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November 12, 2010

Michael Tancredi, Senior Staff Counsel
California Department of Insurance
Legal Division
300 South Spring Street, 12th Floor
Los Angeles, CA 90013

Sent via email to: tancredim@insurance.ca.gov

RE: Amended Text of Regulation 2010-00001, Concerning the Standards and Training for Estimating Replacement Value on Homeowners' Insurance—*Written Comments from the Personal Insurance Federation of California (PIFC)*

Dear Mr. Tancredi:

The Personal Insurance Federation of California ("PIFC") appreciates the opportunity to submit comments to the California Department of Insurance ("the Department") in response to the Modifications to the Amended Text of the Standards and Training for Estimating Replacement Value on Homeowners' Insurance Regulation ("amended regulation").

PIFC member companies provide home, auto, flood and earthquake insurance for millions of Californians. Our member companies, State Farm, Farmers, Liberty Mutual Group, Progressive, Allstate and Mercury, write more than 60 percent of the home and auto insurance sold in this state. In addition, the National Association of Mutual Insurance Companies (NAMIC) is an associate member.

For nearly a year, PIFC has participated in discussions regarding a proposed regulation concerning standards and training for estimating replacement cost as it relates to the purchase of homeowners' insurance. We applauded the successful effort to revise the California Residential Property Insurance Disclosure form and have consistently expressed our support for improved training standards as authorized specifically by statute. We have provided formal and informal comments and attempted to provide the Department with information as to the practical impacts of the amended regulation on both the consumer and the insurance professional. We have also expressed our concern that the Department, while pursuing a worthy goal of creating "…a more

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consistent, comprehensive and accurate replacement cost calculation," has exceeded its statutory authority and has failed to comply with provisions of the Administrative Procedure Act ("APA").

PIFC incorporates, by reference, our letter dated May 17, 2010, detailing questions and concerns with the original proposed regulation, most of which remain. In our comments below, we will attempt to emphasize the amended language and focus our concerns to those provisions.

THE AMENDED REGULATION DOES NOT MEET THE REQUIREMENTS OF GOVERNMENT CODE SECTION 11349.1.

Authority

The authority of an administrative agency to adopt regulations is limited by the enabling legislation. *(Bearden v. U.S. Borax, Inc., (2006) 138 Cal.App.4th 429)*. To be valid, an administrative regulation must be within the scope of authority conferred by the enabling statute or statutes. *(Terhune v. Superior Court (1998) 65 Cal.App.4th 864).* Agencies do not have discretion to promulgate regulations that are inconsistent with the governing statute, or that alter or amend the statute or enlarge its scope. *(Slocum v. State Board of Education (2005) 134 Cal.App.4th 429).*

There is no authority provided by the cited statutes for the Department to create an entirely new definition for commonly used terms as proposed in Section 2695.180(e), *as amended*. This new definition is then referenced throughout Section 2695.183, *as amended*, and serves as the basis for further requirements, prohibitions and even penalties, including the creation of a new violation of Insurance Code Section 790.03 under Section 2695.183(j), *as amended*.

Section 790.10, cited by the Department as authority, is limited to adopting regulations to implement the existing list of unfair business practices set forth in Section 790.03. It is not available to expand the list of unfair business practices as the amended regulation does. Section 790.06 sets out the exclusive process for the Department to add to the list of acts that constitute unfair business practices.

The Department asserts that the regulation is authorized because it is implementing a provision in Section 790.03, making a misleading statement about the business of insurance (Section 2695.183(j)). PIFC does not concede that providing information, that assists an applicant or insured to estimate the cost of replacing the structure to be insured, is a statement about the business of insurance. Even making that assumption, it does not follow that such information is misleading if it is not calculated solely in accordance with the extensive dictates of this regulation.

For example, information provided by a contractor, knowledgeable about local building costs, could form a valid basis for an estimate of replacement cost that is not misleading. Certainly, an estimate of replacement cost could be provided without setting out the factors that went into the estimate or attaching cost to separate components that make up the overall estimate.

Also, an estimate is exactly that – it is an estimate. An estimate does not require the mathematical precision that the Department is mandating by this amended regulation to prevent it from being misleading. An estimate provided with the explanation that it is only an estimate

and that the applicant or insured is to determine the amount of insurance needed to replace the structure is, by definition, non-misleading.

The effect of the proposed regulation is to set out totally new standards and restrictions on communication, making the failure to comply with an additional definition of an unfair business practice. As noted above, the Department cannot do that under the authority contained in Section 790.10 or any other provision of law. Certainly, the regulation exceeds the scope of authority contained in Section 790.03, dealing with misleading statements concerning the business of insurance.

An agency has no authority to promulgate a regulation that is inconsistent with controlling law. *(Communities for a Better Environment v. California Resources Agency (2002) 103 Cal.App.4th 98).* No legal basis exists for the Department to restrict insurance companies from obtaining and/or communicating an estimate of replacement cost, activities that are critical and essential to underwriting decisions, as the *amended regulation* proposes in Section 2695.183.

"The Insurance Code provides no express authority for regulating the underwriting of homeowners' insurance, nor can such expansive authority be implied. Unlike automobile insurance, homeowners' insurance is subject to only a few restrictions, all clearly set forth in the Insurance Code. Reading the Insurance Code to give the Commissioner broad authority to regulate underwriting beyond these specific provisions is inconsistent with the legislative scheme as a whole." *(AIA v. Garamendi).* The Department remains bound by this decision.

The only statutes that restrict an insurance company's underwriting decisions with respect to homeowners' insurance are Insurance Code Sections 676 and 791.12. Other sections set out the basis for canceling a policy (Sections 675, 675.5, 676), or prohibit when a policy may be non-renewed (Sections 675, 676.9, 676.10, 676.1) or prohibit discriminatory practices (Sections 679.7-679.73). **These restrictions are exclusive**. The Department has no authority to expand these restrictions to include restrictions on estimating replacement cost—a fundamental component of any underwriting decision. The underwriting process will almost always necessitate the calculation of an estimated replacement cost to determine: (1) a minimum amount of insurance a company may offer based upon its internal guidelines and (2) the basic coverage amount upon which an extended coverage amount may be offered.

Any attempt to regulate the estimating process fundamentally includes the regulation of underwriting. Section 2695.183(p), *as amended*, proposes to specifically regulate the communication of a "minimum amount of insurance" in conflict with controlling statutory and case law.

Most insurance companies offer extended coverage that is usually some percentage above the basic coverage amount. Extended coverage provides a cushion for the unexpected, rapid increases in construction costs, upgrades, additions and other changes that did not trigger the insured to increase the basic coverage. Extended coverage is based on a basic coverage amount that is equal to or greater than the estimated replacement cost. In fact, extended coverage cannot be provided unless the basic coverage is at least as great as the estimated replacement cost of the property.

Hence, to even discuss extended coverage, the insurance company has to obtain an estimate of the replacement cost and communicate that amount to the insurance applicant. Estimating and communicating the replacement cost is integral to making an underwriting decision, that is, whether extended coverage can be provided or not. Section 2695.183, *as amended*, prohibits

an insurance company specifically from obtaining, estimating, or communicating a replacement cost unless it complies with subdivisions (a) through (e). As such, it directly regulates underwriting.

PIFC does recognize the authority of the Department, under Insurance Code Section 1749.85, to promulgate regulations related to the curriculum and training of broker-agents on "proper methods of estimating replacement value of structures…" However, nothing in that statute, or contained within the legislation's history, can be read to allow the Department the authority to promulgate regulations applicable to broker-agents for any purpose other than to establish a training curriculum. Section 2695.183, *as amended*, attempts to regulate well beyond curriculum by specifying standards and requiring and prohibiting certain forms of communication between the licensee and the consumer.

In addition, the amended regulation appears to conflict with established California law reflecting the responsibility of the insured to set policy limits. "It is up to the insured to determine whether he or she has sufficient coverage for his or her needs." *(Everett v. State Farm General Insurance Co. (2008) 162 Cal.App.4th 649).* The court in *Everett* also affirmed that Insurance Code Sections 10101 and 10102 do not require an insurer to set policy limits that equal the cost to replace the property, nor is an insurer duty bound to set policy limits for insureds. The amended regulation will have the impact of shifting the responsibility for establishing policy limits from the insured to the insurer, contrary to current law.

Clarity

The amended regulation is fraught with ambiguity and fails to meet the clarity standard as defined under the APA Section 11349 (c). "Clarity means written or displayed so that the meaning of the regulations will be easily understood by those persons directly affected by them." An ambiguous regulation that does not comply with the rulemaking procedures of the Administrative Procedure Act (APA) is void. *(Capen v. Shewry (2007) 65 Cal.Rptr.3d 890).*

PIFC and our member companies have spent months in discussions and exchange of information with the Department and yet still the experts within these companies have no clear understanding of the requirements of this amended regulation. Comments and questions related to clarity are provided within the specific section comments below.

Consistency

Consistency is defined in Government Code Section 11349 (d) as "being in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law. An agency has no authority to promulgate a regulation that is inconsistent with controlling law *(Communities for a Better Environment v. California Resources Agency (2002) 103 Cal.App.4th 98*), nor with the governing statute. *(Pulaski v. California Occupational Safety and Health Standards Board (1999) 75 Cal.App.4th 98).*

As discussed above, Section 2695.183, *as amended*, is in conflict with *AIA v. Garamendi* in its attempt to regulate underwriting. This section is also inconsistent with Section 1749.85, which applies to ***training curriculum for broker-agents*** (subdivision (a)) and places a requirement on ***real estate appraisers to calculate an estimate of replacement value in accordance with regulations***, if adopted by the Department (subdivision (d)). The amended regulation goes far beyond training and curriculum by mandating a specific set of requirements for estimating replacement cost for licensees (including broker-agents) in clear conflict with statutory law.

Necessity

Finally, the Department has failed with the amended regulation to satisfy the "Necessity" standard. The record of the rulemaking proceeding fails to "demonstrate by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets or makes specific, taking into account the totality of the record." For purposes of this standard, evidence includes, but is not limited to, facts, studies and expert opinions. (APA Section 11349 (a)). Nothing in the Initial Statement of Reasons or any new information provided in the recent Notice, evidences any need for this regulation. The Department added several "documents" to the rulemaking file. Nothing in the file constitutes studies or expert opinions - the majority are newspaper articles, which can hardly be classified as "expert opinions." The "survey" was conducted by a bias group and offers no scientific methodology or conclusions that could possibly be the basis for the regulation. The Department has not offered any information, other than limited, anecdotal, to justify the need for the amended regulation – no studies and no facts.

Certainly the Department has provided no explanation for why the precise detailed mandates of the amended regulation are necessary to implement Section 790.03. That is, why each and every provision is required to avoid providing an estimate of replacement cost that is misleading. Nothing less is required by the APA.

In promulgating the amended regulation, the Department has failed to meet the requirements of the California Administrative Procedure Act.

SPECIFIC COMMENTS AND QUESTIONS AS TO THE AMENDED REGULATION

Is the Amended Regulation Intended to Apply to Manufactured Homes?

Because of the nature of the type of construction, manufactured homes are generally not reconstructed but replaced following a total loss. Consequently, the reconstruction value estimation process for manufactured homes is significantly different as compared with site-built homes. Specifically, replacement value estimators for manufactured homes generally do not provide for provisions for cost of foundation or architect's plans/engineering reports/permits, whether the structure is located on a slope, the type of frame, or nonstandard wall heights.

Since estimating programs are not generally available for manufactured homes that incorporate all of the provisions required by Section 2695.183 and because the training required for manufactured homes is significantly different than site-built homes, it would seem appropriate to exempt manufactured homes from the proposed regulation.

We raised this issue during the previous comment period and there has been some indication that the intent is that the amended regulation does ***not*** apply to manufactured homes, but as written, there is a lack of clarity. Would the Department please indicate its intention and clarify the language?

Section 2695.180 (e), as amended

This section broadly defines the terms "estimate of replacement cost" and "estimate of replacement value" as "any estimate, statement, calculation, approximation or opinion, whether expressed orally or in writing, regarding the projected replacement value of a particular structure or structures."

The definition is so broad as to encompass almost any conversation that would take place between a licensee and a customer, thereby triggering all of the requirements in Section 2695.183 and resulting in a myriad of unintended consequences and downstream regulatory ramifications. It could very well lead to consumer confusion because its breadth could be interpreted to be akin to market value, which would be completely inaccurate. Specifically, the proposed definition of "estimate of replacement cost" is subsequently referenced in many other sections of the amended regulation and makes it impractical and infeasible for a licensee to ensure compliance with the amended regulation:

> 2190.3(f): Requirement to maintain records and copies of the estimate of replacement cost;
> 2695.183(e): Requirement for a licensee, no less frequently than annually, to take reasonable steps to ensure that sources and methods used to generate the estimate of replacement cost are kept current;
> 2695.183(g)(1): Requirement to provide a copy of the estimate of replacement cost to the applicant or insured at the time the estimate is communicated;
> 2695.183(g)(2): Requirement that the estimate of replacement cost itemize the projected cost for each element of Section 2695.183(a)(1)-(a)(4);
> 2695.183(h): Requirement to provide a copy of the revised estimate of replacement cost if the estimate has been revised; and
> 2695.183(i): Requirement to maintain a record of the information used to generate the estimate of replacement cost and a copy of the estimate of replacement cost in the file for the prescribed period of time.

Because the scope of the definition for "estimate of replacement cost" has been expanded to include oral approximations or opinions, it is not possible for a licensee to generate a printed or an electronic copy of any additional adjustments outside of the software provided that would support the revised oral "estimate", as required by Section 2695.183(g)(1) which is a consequence of a private conversation between the agent and applicant.

Also, because the licensee would not be aware of specific details exchanged in any private conversations, it is not possible to maintain a record of the information used to generate this revised "estimate of replacement cost," as required by Section 2695.183(i) and Section 2190.3(f).

Since an adjustment which occurs outside a licensee's system-generated estimating process (i.e., based on information from an oral conversation) is not captured, it would not be possible to itemize the elements listed in Section 2695.183(a)(1) - (a)(4) to support the revised oral estimate, as required by Section 2695.183(g)(2). Next, since the licensee does not have any record of any oral adjustments, it is not possible for the licensee to maintain a physical or electronic copy of the revised estimate of replacement cost in the file as required by Section 2190.3(f) and Section 2695.183(h).

Finally, it is not practical for an insurer to "take reasonable steps" to ensure that personal information or experience base that is discussed in private, oral conversations, be annually updated (as required by Section 2695.183(e)).

Section 2695.183, as amended
Several substantive changes have been made to this Section which raise the question of whether the amended regulation satisfies the requirement of the APA Section 11346.8(c): The change must be either: (1) nonsubstantial or solely grammatical or (2) sufficiently related to the original text that the public was adequately placed on notice that the change could result from the originally proposed regulatory action.

The term "communicate" which is actually used throughout the amended regulation, lacks clarity. The change in the first sentence of the amended regulation from a prohibition on a licensee to "estimate a replacement cost" (unless the specified standards are met), to the amended language which now states that no licensee shall "communicate" an estimate (unless the specified standards are met) is unclear. Because the term "estimate of replacement cost" is defined so broadly in Section 2695.180(e), the intent of this amendment needs to be clarified.

Other substantive amendments include the addition of the language, still in the first sentence, "…in connection with an application for or renewal of…" Would the Department please clarify the phrase "in connection with"? The inclusion of renewals within the requirement creates a new and substantial burden on insurers, essentially shifting the responsibility of determining coverage from the insured to the insurer – in direct violation of the *Everett* decision. It creates a situation where simply by sending the renewal notice the requirements of complying with the standards (a) through (e) would apply or place the insurer at risk for being found to have violated Section 790.03 (per subdivision (j)). Can the Department explain what is intended? Does the Department intend to change existing law to force insurers to determine coverage upon renewals, even if a customer does not want this?

Currently, the applicant/insured has full responsibility for providing all information necessary for a non-binding estimate of coverage. The broker-agent may assist the applicant/insured by utilizing that information to estimate replacement cost, sharing that information, but relying on the applicant/insured to determine the coverage amount best for them. Does the Department intend that the amended regulation will require a change in this practice?

Current practice also includes situations where an applicant/insured provides a contractor or other estimate of replacement cost prepared by a third party. Would that "communication" trigger all of the requirements of this section and put the broker-agent in the position of having to verify that estimate by attempting to comply with subdivisions (a) through (e)?

Section 2695.183(g)(2), as amended
The requirement to itemize the projected costs will necessitate changes to the business practices of most companies and include modifications to vendor systems and company systems requiring substantial cost and time to achieve the ability to comply. We also raise the concern of how the itemized figures may be used *after the fact* during the claims process, which could be years removed from the initial estimate, in a circumstance where no subsequent estimate was prepared and policy limits go unchanged because the consumer did not increase their limits– which, given the burden on the licensee if they choose to prepare an estimate, not preparing subsequent estimates may become a more common practice. The responsibility to obtain sufficient insurance is on the insured – but they often do not update their policies, in spite of being encouraged to do so routinely by their agent or company.

Section 2695.183(j), as amended
This subdivision expands the prohibitions under Insurance Code Section 790.03. This may not be done by regulation, rather an expansion of this type must be passed by the legislature or in accordance with Section 790.06. The Department has no authority to expand the list of unfair business practices by regulation. "If, in adopting an administrative regulation under this section, a state agency does not confine itself to a reasonable interpretation of the statute, the legislative area has been invaded and courts are obligated to strike down an administrative rule which attempts to add to or subtract from the statute." (*Macomber v. State Social Welfare Bd. (1959) 175 Cal.App.2d 614).* "Agencies do not have discretion to promulgate regulations that are inconsistent with the governing statute, or that alter or amend the statute ***or enlarge its scope***." (*Sabatasso v. Superior Court (2008) 167 Cal.App.4th 791). Emphasis added.*

PIFC has continually expressed our concern that this provision could create a litigation path for industrious lawyers. The amended regulation is a compilation of overly prescriptive requirements which also lack clarity and even conflict. Compliance will be difficult and disagreements about what was "communicated' (the regulation includes all oral communication as well) will take place at the time of claim, perhaps years removed from the initial estimate. process. The amended regulation, and specifically this provision, are fraught with litigation traps.

Section 2695.183(n)
This subdivision states that no provision of this article shall "limit or preclude" a licensee from "providing and explaining" the required California Residential Property Insurance Disclosure, nor from "explaining the various forms of replacement cost coverage" nor from "explaining how replacement cost basis policies operate." However, this language does not provide any exemption or protection for "communication" as is provided in subdivision (l) and given the broad definition of 2695.180(e), this provision does not appear to offer any protection for the licensee in discussing the required disclosure forms.

Section 2695.183(o)
This subdivision, while allowing the applicant to obtain his or her own estimate, does not explain how that estimate may be used in any communication with the licensee, nor whether the act of accepting an estimate provided by an applicant will trigger the requirements on the licensee under this Section and subject a licensee to the definition in Section 2695.180(e), triggering potential liability under Section 2695.183(j).

Section 2695.183(p)
Comments with respect to the legal authority of the Department to regulate the calculation and communication of the "minimum amount of insurance" requirement a company may have as a part of their underwriting guidelines was discussed above.

This entire subdivision is confusing. It appears to conflict with subdivision (l) which states that "Section 2695.183 applies to *all communications* by a licensee, verbal or written, with the *sole exception* of internal communications….that concern the insurer's underwriting decisions and that never come to the attention of the applicant or insured." How can the insurer not communicate issues relating to minimum amount of insurance and how can the internal process not fall under the broad definition of an estimate of replacement cost? The first part of subdivision (p) seems to be an exception allowing communication, yet the second part of subdivision (p) seems to be a trap depending upon what words or phrases are used, particularly given that most internal processes will include some sort of estimate. Insurers need clear guidance on how to comply with this provision.

Section 2695.183(q)
This provision regarding an extended implementation date is appreciated, though 180 days is likely not sufficient time to make the vendor and system changes necessary to comply with the provisions of the amended regulation.

With all due respect for the impact to any homeowner who has inadequate insurance at a time of loss – due to any number of reasons – the number of insureds in that situation are few compared to the overall insured homeowner population and even to those who suffer a loss. Yet, this proposal would disrupt the relationship and responsibilities of everyone who applies for and purchases homeowners' insurance. The Department still has produced no evidence that its stated goal will be achieved or that regulating the estimating process to the point of dictating the words and phrases used in a conversation will have any measurable effect on reducing the number of homeowners who find or believe themselves to be without adequate coverage at the time of a claim.

PIFC supports improved and additional training requirements for broker-agents. We supported the Department's efforts to improve the disclosure process and increase consumer knowledge to allow better decisions for adequate coverage (AB 2022 (Gaines)). We also support the Department's efforts to better educate homeowners on the importance of choosing adequate coverage limits. We look forward to continuing to work with the Department on ways to decrease the likelihood of insureds having inadequate coverage. The proposed regulation Section 2695.183, however, will not achieve that goal, nor do we believe the Department has the authority to promulgate this regulation. We respectfully request that the Department withdraw this section from the amended regulation.

As we have for the past year, PIFC stands ready to work with the Department, but we must adamantly oppose this amended regulation.

Thank you for your time and consideration. Please feel free to contact PIFC's General Counsel, Kimberley Dellinger Dunn via email at kdellingerdunn@pifc.org or by phone at 916-442-6646 or PIFC's Legislative Advocate, Ermelinda Ruiz via email at eruiz@pifc.org or by phone at the number listed above, if you have any questions about PIFC's written comments.

Respectfully,

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