Formerly The Foundation for Taxpayer & Consumer Rights
1750 Ocean Park Boulevard, #200, Santa Monica, CA 90405-4938 • Tel: 310-392-0522 • Fax: 310-392-8874 • www.consumerwatchdog.org

April 30, 2008

By Electronic Mail

The Honorable Steve Poizner
Insurance Commissioner
State of California
45 Fremont St., 21st Floor
San Francisco, CA 94105

> "Insurers this week welcomed a new set of emergency regulations introduced last week by Insurance Commissioner Steve Poizner."
> – Insurance industry publication "Smart's Insurance Bulletin," April 30, 2008

Dear Commissioner Poizner:

The latest changes to the Proposition 103 Rate Regulations that your office issued last night, under the guise of an ostensible "emergency," reveal that key elements of the changes reflect – sometimes almost word for word – proposals made by the insurance industry to cripple the regulations. Your proposals are an outrageous giveaway to the insurance industry, and it will come as no surprise that if these hastily adopted amendments go into effect, the result will be unnecessary insurance premium increases for Californian consumers and businesses – particularly for motorists and homeowners - and excessive profits for insurance companies.

Specifically, you propose adopting the following industry-backed changes without providing the public with the traditional opportunity to review and comment on them:

• Allow insurers to increase their rates in order to earn profits far in excess of what is justified under Proposition 103.

• Permit insurers to game the regulatory system by inflating the projected amount of payments of future claims they can pass through to current policyholders.

• Allow insurers to buy unregulated "reinsurance" and then pass all such expenses on to policyholders, while denying consumers the right to challenge the cost of the reinsurance or any conflicts of interest or kickbacks.

Moreover, the amendments will upset the carefully devised plan under which all auto insurance companies are supposed to comply with Proposition 103's dictate that premiums be based primarily upon a person's driving safety record, rather than zip code, effective August 13, 2006.

The Proposition 103 Rate Regulations have served Californians well – saving motorists alone over $62 billion since 103's passage in 1988, according to a report issued just last week – and there is no justification for this unprecedented giveaway to the insurance industry, much less any "emergency" warranting your attempt to ramrod these changes into effect without the full public hearings required by Proposition 103.

When you ran for the post of elected Insurance Commissioner, you promised not to interfere with the Proposition 103 Rate Regulations that were adopted by Insurance Commissioner Garamendi after years of study to lower auto, home and business insurance rates. We urge you to honor the pledge you made to the voters when you ran for office and withdraw these proposed regulations immediately.

History of The Proposition 103 Rate Regulations

As you know, under Proposition 103, approved by voters in 1988, insurance companies that want to change their rates must first open their books and show they are complying with the rules, issued by the Insurance Commissioner, that limit their profits and expenses to fair levels before the Commissioner can approve the rates. The Proposition 103 Rate Regulations were put into place by Insurance Commissioner John Garamendi in 1991, and later unanimously upheld by the California Supreme Court in 1994 after a legal challenge by the insurance industry. The regulations forced insurance companies to refund $1.2 *billion* in overcharges to auto, home and business insurance policyholders after the measure's passage.

The Proposition 103 Rate Regulations are responsible for most of the $61.8 billion that the Consumer Federation of America calculated California motorists have saved since the passage of Proposition 103, according to the one hundred-page report the published last Thursday.

During his second term, Insurance Commissioner Garamendi determined that it was necessary to amend the regulations in order to reduce rates and profit levels that had become excessive under his predecessors Chuck Quackenbush and Harry Low. Commissioner Garamendi also recognized that changes were necessary to make sure the California Department of Insurance (CDI) could quickly and efficiently process rate reductions as part of his plan to enforce a separate Prop 103 requirement that motorists' premiums be based on their driving record rather than zip code (the Auto Rating Factor Regulation). Beginning in 2005, the CDI conducted a two year process of public hearings and workshops, attended by representatives of virtually every insurance company in the United States, to determine how to *strengthen* the regulations in order to

best serve consumers. The final product, adopted by Commissioner Garamendi, made the Proposition 103 Rate Regulations easier to apply consistently by the staff of the CDI, and prevented insurance companies from manipulating financial data to obtain unjustified rate increases. These changes went into effect in April 2007.

While Commissioner Garamendi made a number of changes in the regulations that were requested by the insurance industry, proposals by the industry that would have effectively nullified the Proposition 103 Rate Regulations were exhaustively analyzed by the CDI staff and rejected.

The Industry Assault on Regulations after Your Election, and Your Capitulation

Shortly after you took office, we received word that the CDI was considering making minor, technical changes to the regulations. In particular, we were told, the CDI wanted to address the provisions that allow insurance companies to request an *exemption,* or "variance," from the application of the Rate Regulations. At the time, it was widely understood that the insurance companies were continuously requesting variances from the regulations that would allow them to charge rates that were higher than necessary. CDI staff suggested that the variances needed to be tightened or eliminated. Consumer Watchdog submitted written comments on the topic of the variances on April 24, 2007, and again in November, 2007. At the same time, we warned that re-opening the prior approval regulations, even if only to address "variances," would prove an irresistible opportunity for the insurance industry to seek broader changes in the Regulations.

We heard nothing more until January, when we learned that insurance companies were meeting with your staff to discuss changes in the prior approval regulations that went far beyond minor technical changes. When we inquired, we were informed that indeed discussions were underway. On February 13, 2008, Consumer Watchdog staff as well as myself participated in a meeting in San Francisco with CDI staff at which they read to us an extensive list of changes to the Garamendi regulations. The changes were far from the minor, technical "tweaks" that we had been advised were under consideration. Rather, it was clear that you were contemplating radical changes to key elements of the regulations that had only been in effect for *ten months*. Many of the proposed changes were identical to those that the insurance industry had previously sought but Commissioner Garamendi had rejected after extensive study.

Until this point, there had been no opportunity for any members of the public, including us, to review the language of the changes under consideration. Then, on March 19, 2008, the CDI published an official notice of proposed changes to the Proposition 103 Rate Regulations. The notice asserted that the Regulations needed to be changed on an emergency basis, and called for a *one-day* public "workshop," which was held on April 7, 2008. Representatives of the entire national insurance industry were there in force; other than Consumer Watchdog, no other consumer groups and no other members of the public attended. Consumer Watchdog submitted a twenty page letter analyzing the proposed changes, explaining how they would undermine CDI's regulation of rates, public scrutiny

of the process, and lead to higher insurance premiums, as well as pointing out the significant technical drafting problems that would lead to confusion if not corrected. We also objected to the attempt to short-circuit public scrutiny by decreeing an emergency that would permit the proposed changes to take effect virtually immediately.

Last Monday, April 21, the Department issued what it said were the results of its deliberations and the written comments from interested parties – all of which were insurance companies and insurer lobbying organizations with the exception of Consumer Watchdog.

By now, very little about the process you established could have surprised us. Nevertheless, we were astounded to discover that additional changes – changes never proposed by the CDI or presented to the public for discussion – had been inserted into the April 21 proposal. In every case, the additions further undermined and weakened the Proposition 103 Rate Regulations, and would inexorably lead to higher insurance rates for Californians. However, not one of the objections stated in our April 7 letter were addressed by the April 21 proposal. We once again contacted CDI, and you, to request an explanation for items that were either a complete contravention of previous positions of the CDI or else poorly crafted and confusing.

But that was not the end of it, of course. Last night, you issued another version of the regulations which contains even more changes that have never before been presented to the public and that will enable insurance companies to further boost their profits – already deemed excessive by the Consumer Federation of America report – at the expense of California consumers, homeowners and businesses.

By Adopting the Insurance Lobby's Proposals, Your Regulations Will Lead to Higher Premiums

Your proposal represents a massive and unjustified giveaway to the insurance industry:

<u>1. Your changes to the regulations will allow insurers to increase profits by charging rates far in excess of what is justified under Proposition 103. (Amendment to Section 2644.16 of Title 10 of the California Code of Regulations - April 29 revision.)</u>

Limiting insurance companies to a fair "rate of return" – a reasonable profit – is one of the most crucial money-saving aspects of the Proposition103 Rate Regulations. Last night's proposal inserted a brand new change that allows an insurance company to obtain a special 2% increase in the maximum lawful rate of return which is used to calculate its profits. There is no possible justification for this change, on an emergency basis or otherwise. Increasing the permitted rate of return directly increases the amount of premium the insurance company can charge – on a one-to-one basis.

For example, a 2% increase to the maximum rate of return in the recent Allstate auto case would have allowed Allstate to collect an additional $32 million in premium annually.

While changes to the rate of return regulation were not part of the changes proposed by CDI, the industry has constantly lobbied for the right to higher profits and the insurers' suggestions are now part of your proposal.

For example, the industry's main Sacramento lobbying group, the Personal Insurance Federation of California proposed such a change on November 28, 2007: ("We request modification of Section 2644.16, as follows: (a) The maximum permitted after-tax rate of return means the risk-free rate, as defined in section 2644.20(d), plus ~~6%~~ 8%."[1]). At the April 7, 2008 "workshop," the state's largest malpractice insurer stated: "The Department should consider either adding a rate of return variance separate from the confiscation standard or amending section 2644.16 to provide for an 8% market risk premium."[2]

Also contributing to insurers' ability to increase profits at the expense of consumers is your new rule that will allow insurers to use more of their retained earning to calculate a higher profit margin that will be built into the rates customers are charged. This so-called "leverage factor" change will have the worst impact on auto and homeowners insurance premiums.

2. Your changes to the regulations will allow insurers to inflate the projected amount of future claims payments that they can pass through to current policyholders.
(Amendments to Section 2644.7 of Title 10 of the California Code of Regulations –April 21 revision.)

One of the ways that insurance companies routinely seek to game the regulatory process is to inflate estimates of how much they will pay out in claims in the future. Such estimates are used to set how much money current policyholders must pay for insurance. Rejecting the protestations of the insurance companies, Insurance Commissioner Garamendi determined that insurance companies' estimates of how much they will pay out in claims in the future should be uniformly and fairly determined by looking to their actual claims paid over the most recent three years.

Your proposal would allow the insurer to present loss data over 2, 3, 4, 5, or 6 years, but then goes on to allow the company to calculate the proposed rate based on the period that they consider to be "most actuarially sound." The regulation states that "the Commissioner may require the use of an alternative data period if "the Commissioner determines that use of the alternative is the most actuarially sound."

---

[1] Comments of PIFC on Variance Process, Nov. 28, 2007, p. 8.
[2] Comments of The Doctors Company, April 7, 2008, p. 8.

This change effectively deregulates the component of the Rate Regulations used to project future claims payments.

Your office has attempted to support this change by arguing that it gives the CDI more flexibility to order a lower rate. This is highly disingenuous. As anyone who is familiar with the CDI's functioning is well aware, the CDI does not have sufficient staff to review and calculate alternative rates in every one of the thousands of rate applications it receives every year. Indeed, as the California Supreme Court noted in upholding the Proposition 103 Rate Regulations, without single, uniform methodologies, the result is "*standardless, ad hoc decision making.*" (*20th Century Insurance Co. v. Garamendi* (1994) 8 Cal.4th 216, 312.) That is why the Proposition 103 Rate Regulations issued by your predecessor requires the Commissioner to use "a single, consistent methodology" to review rates. (Cal. Code Regs., tit. 10, § 2643.1.)

As a practical matter, insurers will simply use the particular loss methodology that will produce the highest rate, and absent far more staff than is currently available, the CDI will end up approving the insurer's request.

That, of course, is why the insurance industry requested that the regulations be changed exactly as you have done. Indeed, your change is almost verbatim what the industry lobbyists proposed you adopt.[3]

3. Your changes to the regulations will allow insurers to buy excessive amounts of reinsurance, which is unregulated and the source of numerous scandals in recent years, and pass the cost of such reinsurance on to policyholders, while denying consumers the right to challenge the cost, or any sweetheart deals or conflicts of interest. (Amendments to Section 2644.25(d) of title 10 of the California Code of Regulations –April 21 revision.)

Reinsurance is insurance purchased by insurance companies as a way to cover possible claims and at the same time sell more insurance than they would otherwise have the reserves to cover. Reinsurance is typically provided by insurance companies that are not regulated in any way. In 1991, Commissioner Garamendi refused to permit insurance companies to pass through to consumers the cost of the reinsurance they buy, explaining:

---

[3] See, for example, Comments by Shawna Ackerman on behalf of PIFC, ACIC, AIA, Apr. 7, 2008, p. 7 [advocating shorter periods for trend of four, six, and eight quarters of data by stating that "this approach was reviewed and allowed prior to the implementation of the April 2007 regulations"]; Comments of Fireman's Fund, Apr. 7, 2008, p. 2 [proposing language adopted in Apr. 21 draft that would allow ***insurers*** to select and use "the most actuarially sound trend" period from among the specified quarter periods]; Comments of CSAA, Apr. 7, 2008 [advocating that the insurer be permitted "to select the number of quarters and demonstrate that the number chosen is actuarially sound" and to expand the selection to 8 and 32 quarters].

> Since reinsurance rates are themselves exempt from regulation under Insurance Code section 1851, regulating only net premium would leave insurers free to add a wholly unregulated reinsurance cost to the price the consumer pays, undermining the whole regulatory program. The Department has rejected this comment in favor of calculating all rates on the basis of direct premium, for which no adjustment for reinsurance costs is appropriate.[4]

In recent years, the insurance industry has been rocked by scandals involving sweetheart deals and kickbacks between insurance and reinsurance companies that made it difficult for regulators or consumers to determine the true price of the reinsurance coverage.

The 2006 amendments to the regulations permitted insurance companies to pass through to consumers the cost of reinsurance bought for earthquake and medical malpractice insurance. To address concerns raised by Consumer Watchdog that this would result in sharply higher, excessive premiums, the 2006 regulations require that (1) "the reinsurance agreement was entered into in good faith in an arms-length transaction and at fair market value for the coverage provided;" (2) no pass through of reinsurance between affiliates is allowed; (3) no pass through of reinsurance through unauthorized reinsurers is allowed; and (4) the Commissioner hold a hearing upon a consumer's request when an insurer seeks to include reinsurance costs that amount to 30% or more of the proposed rates.

Your new regulations gut these consumer protections. One of the changes appears to limit a consumer's ability to challenge the "reasonableness" of the reinsurance costs sought to be passed through to consumers.

Moreover, the April 21 amendments contain a brand new amendment that was not subject to any public comment. This change eliminates the prohibition against passing through to consumers the costs of reinsurance obtained through unauthorized reinsurers. Again, such a change was raised only by insurance companies. (See Ackerman comments, Apr. 7, 2008, p. 11 ["The CDI should clarify what it means and how it intends to apply section (f) as to the term 'unauthorized reinsurers'"].) This change will inevitably translate into higher insurance rates as companies would be allowed to pass through more reinsurance costs obtained through reinsurers who are subject to absolutely no oversight or regulation by the CDI. By eliminating this requirement, the Commissioner is opening the door to higher earthquake insurance rates for homeowners and higher malpractice insurance rates for doctors.

Your "Emergency" Proposal Derails Full Public Scrutiny and Endangers the Transition to Good Driver Based Rates

In 2006, after decades of court cases and regulatory battles, Insurance Commissioner Garamendi issued regulations enforcing Proposition 103's requirement that auto

---

[4] CDI Rulemaking File RH-291, Vol. 2, Summaries and Responses, 1991, Response to Comment No. 6 (John Dodsworth, Cal. Accountants Mutual Ins. Co.), p. 17.

insurance rates be based primarily upon a person's driving safety record, rather than zip code.

In order to ensure a smooth transition to these new Good Driver Regulations, and to ensure that overall premiums were as low as possible, the Commissioner amended the Proposition 103 Rate Regulations as discussed above. The transition to 100% compliance with the Good Driver Regulations is to be completed by all insurance companies by July 14, 2008. By that date, automobile insurers are required to submit applications showing full compliance with the Good Driver Regulations and with the Proposition 103 Rate Regulations.

As a candidate, you also committed to respecting the Good Driver Regulations:

> "Proposition 103 (section 1861.02(a)) makes a person's driving record, annual miles driven and years of driving experience the primary factors in auto insurance pricing. As Insurance Commissioner, I support and will defend the newly issued regulations under section 1861.02(a)."

Inexplicably, you have proposed that the changes to the Proposition 103 Rate Regulations be adopted on an "emergency" basis, so that they take effect immediately – so that they will apply to the applications that must be filed by July 14.

There is, of course, no "emergency," which is defined by Government Code section 11342.545 as "a situation that calls for immediate action ***to avoid serious harm to the public peace, health, safety, or general welfare***." The haste by which these changes have been proposed is a testament only to the power of the insurance lobby to obtain immediate action from you. The result is, first, poorly drafted and confusing language that will undermine the credibility and integrity of the regulatory process.

Second, by declaring an 'emergency,' you have deprived California consumers of their right to carefully scrutinize the changes you are adopting at the behest of the industry and hold a public debate on them. This is a right that is enshrined in Proposition 103. No doubt you do not wish your handiwork to be subject to such careful scrutiny, but your decision to abruptly and largely in secret overturn the exhaustively studied and carefully vetted prior regulations is a violation of your obligations to the public.

Finally, the changes you propose will add an enormous burden to the staff of the CDI as insurance companies submit thousands of pages of documentation by July 14, 2008. Indeed, there is a real danger that the proposed regulations will hobble that process and result in rate increases at a time when motorists were assured of across the board reductions in their auto insurance premiums.

By Siding with the Insurance Industry, You Have Abandoned The People Who Elected You

It took nineteen years for the Proposition 103 Rate Regulations to withstand the numerous court challenges brought by the insurance industry and evolve to the point where they have made California the best state for insurance consumers in the nation, according to the Consumer Federation of America. As a candidate for insurance commissioner, you were well aware of how important it was that Commissioner Garamendi's regulations went into effect on schedule and in full. Indeed, in a public statement in October, 2006, one month prior to the election, you said:

> "Proposition 103 requires a clear and unambiguous formula for prior review and approval of insurance rates. Currently consumers and insurers are working with the Department to finalize amendments to the formula. I support these efforts and, if needed, I will work to complete the task of providing specific parameters for rate approvals in the future. These rules are necessary to provide clear and unambiguous standards that properly and fairly implement the mandate of the voters that rates not be excessive, inadequate or unfairly discriminatory."

If you proceed to implement your proposed regulations, you will break this pledge to the People of California. As explained above, your proposal replaces the "clear and unambiguous standards" issued by Commissioner Garamendi after exhaustive study and public hearings, and replaces them with a series of vague loopholes, trapdoors, tricks and escape clauses that will enable insurance companies to win excessive rates. Instead of "completing the task," your regulations will derail the program. Last Monday, your press office issued a news release that heralded your proposal as providing "Tools To Keep Rates As Low As Possible" and would "make the rate filing process more efficient, accurate and transparent." The changes will have the opposite effect.

In any case, no amount of spin from your office is going to conceal the higher prices on their insurance bills that consumers will receive as the industry takes advantage of the changes to reap higher prices and profits. Indeed, insurers are no doubt preparing their rate increase requests right now. Even in a normal downturn, insurance companies seek to raise premiums to offset losses in their investments. But the grave deterioration in the financial sector caused by the Wall Street mortgage crisis is going to hit the industry's portfolios harder than ever, and your new regulations give them plenty of opportunity to make up their losses on the backs of consumers.

Finally, in recent days, I have heard a variety of explanations for your capitulation to the industry on these regulations. Some suggest that currying favor with the industry will advance your short-term political interests. I think that very unlikely – fair insurance rates is a non-partisan matter for all but a few Californians, and has been that way since Election Day in 1988. It is also said that the changes comport with your "philosophy," but with all due respect, you were not elected to impose your philosophy on the people of California. You were elected to protect the public against the greed and abuse of the

insurance industry by zealously enforcing the laws and regulations that have delivered hundreds of billions of dollars of savings and a market that the Consumer Federation of America described as the fourth most competitive in the nation. Finally, I have heard the argument that these changes were not dictated by the insurance industry but rather proposed by CDI staff. I do not know which staff that is supposed to be, but those of us who have worked with the dedicated men and women of the CDI for many years do not believe that these regulations, which just so happen to track the industry's own proposals, were their idea.

I urge you to adhere to the pledge you made to voters by withdrawing your proposed regulations immediately.

Sincerely,

Harvey Rosenfield