

RATE APPROVAL REGULATIONS
POTENTIAL AMENDMENTS
DISCUSSION DRAFT

TITLE 10. INVESTMENT
CHAPTER 5. INSURANCE COMMISSIONER
SUBCHAPTER 4.8. REVIEW OF RATES
ARTICLE 4. DETERMINATION OF REASONABLE RATES

§ 2644.12. Efficiency Standard

(a) The Commissioner shall calculate the efficiency standard annually, within 45 days of the publication of the necessary source data, which shall be expressed as a maximum *and minimum* allowable ratio of historic underwriting expenses, including adjusting and other expenses, to historic earned premiums, which represents the fixed and variable cost for a reasonably efficient insurer to provide insurance and to render good service to its customers.

(b) The efficiency standard shall be set separately for each insurance line, and separately for insurers distributing through independent agents and brokers, through exclusive agents, and through employees of the insurer selling insurance on a direct basis. For an insurer using more than one distribution system, the efficiency standard shall consist of an average weighted by earned premium for each distribution system. In setting the efficiency standard, the Commissioner shall determine whether, in the long-term, efficiency will be enhanced and premiums lowered by adopting a separate standard for insurers writing large and small amounts of insurance in the line. If the Commissioner determines that such separate standards would have such long-term effects, he or she shall set the standard separately according to the amount of insurance being written in the line, pursuant to section 2646.3. In lines where the number of insurers employing a given distribution system is, in the judgment of the Commissioner, inadequate for the calculation of a mean that provides a useful efficiency standard, the Commissioner shall adopt a single efficiency standard for that line, pursuant to section 2646.3, which shall apply to all insurers writing in that line regardless of distribution system. For lines of business that combine personal and commercial exposures, the commissioner may set separate efficiency standards, pursuant to section 2646.3.

(c) The *maximum* efficiency standard shall be calculated as *one standard deviation above* the arithmetic average of the latest three years for which data are available. *The minimum efficiency standard shall be calculated as one standard deviation below the arithmetic average of the latest three years for which data are available. In any rate application in which the insurer's actual expense ratio is above the minimum efficiency standard and below the maximum efficiency standard, the insurer's actual expense ratio shall be employed in place of the efficiency standard.*

(d) For farmowners, the *maximum and minimum* efficiency standard for captive insurers shall be *based upon* the average for all distribution systems combined.

(e) For earthquake, the *maximum and minimum* efficiency standard shall exclude adjusting and other expenses. Adjusting and other expenses shall be added to defense and cost containment expenses.

(f) For burglary and theft, all distribution systems shall be combined, and a five-year average shall be used.

(g) In each category, the *maximum and minimum* efficiency standard shall be set at *based upon* the weighted mean (weighted by earned premium in California) expense ratio of insurers in that category. In calculating the average, the Commissioner may exclude insurers for which reliable data are not readily available.

(h) All data shall be taken from the National Association of Insurance Commissioners database of the statutory annual statement state page and of the Insurance Expense Exhibit, Part III.

(i) A company's data shall be included in the calculation only if

(1) The company is licensed in California;

(2) The company's California direct earned premium is greater than zero;

(3) The company's countrywide direct earned premium is greater than zero;

(4) The company's countrywide direct losses incurred is greater than zero; and

(5) The company's ratio of underwriting expenses, including adjusting and other expenses, to earned premium is greater than zero and less than 65%.

(j) If a company's commission expense is less than zero, the negative amount shall be set to zero.

(k) If a company's California allocated other acquisition expense is less than zero, the negative amount shall be set to zero.

(l) If a company's California allocated general expense is less than zero, the negative amount shall be set to zero.

(m) If a company's tax, licenses and fees expense is less than zero, the negative amount shall be set to zero.

(n) Countrywide expenses for general and other acquisition expenses shall be allocated to California on the basis of direct earned premium. Countrywide expenses for adjusting and other expenses shall be allocated to California on the basis of direct incurred losses.

AUTHORITY:

Note: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; and 20th Century v. Garamendi, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; and Calfarm Insurance Company v. Deukmejian (1989) 48 Cal.3d 805.

§ 2644.16. Rate of Return

(a) The maximum permitted after-tax rate of return means the risk-free rate, as defined in section 2644.20(d), plus 6%.

(b) The minimum permitted after-tax rate of return shall be -6%, which the Commissioner finds is high enough to prevent any undue risk of insolvency and to prevent injury to competition through predatory pricing.

~~(c) The Commissioner may increase or decrease the maximum permitted after-tax rate of return by not more than 2% if he finds financial market conditions to be such that the difference between the risk-free rate and the cost of capital is significantly different from its historical average.~~

AUTHORITY:

Note: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; and 20th Century v. Garamendi, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; and Calfarm Insurance Company v. Deukmejian (1989) 48 Cal.3d 805.

§ 2644.27. Variance Request

(a) A request that the maximum permitted earned premium or minimum permitted earned premium should be adjusted is referred to as a "variance request."

(b) Requests for variances shall be filed with the Rate Filing Bureau on pages 11a and 11b of the Prior Approval Rate Application. All such variance requests shall specifically:

(i) identify each and every variance request;

(ii) identify the extent or amount of the variance requested and the applicable component of the ratemaking formula;

(iii) set forth the expected result or impact on the maximum and minimum permitted earned premium that the granting of the variance will have as compared to the expected result if the variance is denied; and

(iv) identify the facts and their source justifying the variance request and provide the documentation supporting the amount of the change to the component of the ratemaking

formula.

(c) Requests for variances shall be filed at the same time as the prior approval application to which it applies or after the filing of the rate application and before any final determination regarding that application. Public notice of all variance requests shall be provided as set forth in California Insurance Code Sections 1861.05(c) and 1861.06.

(d) A variance request shall be deemed approved sixty days after public notice unless:

(i) a consumer or his or her representative requests a hearing within forty-five days of public notice and the Commissioner grants the hearing, or determines not to grant the hearing and issues written findings in support of that decision, or

(ii) the Commissioner on his or her own motion determines to hold a hearing.

(e) Variance requests shall be determined in conjunction with the related prior approval application or rate hearing thereon.

(f) The following are the valid bases for requesting a variance:

(1) That the insurer should be allowed relief from the efficiency standard for bona fide loss-prevention and loss-reduction activities as set forth below.

(A) The insurer meeting the qualifications set forth below may obtain an increase in the applicable efficiency standard by the amount of its "Allocated Costs" for its Special Investigations Unit ("SIU") expense for the most recent year. The term SIU as used in this section has the same meaning as that term has in Section 2698.30(o). The term "Allocated Costs" means those costs set forth in subsection (iii) and attributable to investigations of claims made on the line of insurance subject to Insurance Code section 1861.05(b) for which the variance is sought.

(i) An insurer may recover its "Allocated Costs" for its SIU expenses only in its approved rate filing for the line of insurance affected by the SIU investigation costs.

(ii) Affiliated insurers who utilize the same SIU unit may recover the portion of their "Allocated Costs" for their SIU expenses attributable to investigations of claims made on the line of insurance in the rate application only in one approved rate application for the line affected by the Allocated SIU costs. The term "Affiliated Insurers" has the same meaning as that term has in Insurance Code Section 1215.

(iii) The only recoverable SIU expenses are those expended for investigators whose sole duties are investigation of insurance fraud, software dedicated solely to analysis of data for indications of insurance fraud, training of employees whose sole duty is the investigation of fraud and equipment to be used solely by the insurer's SIU. The recoverable expenses do not include the costs of employing or other costs for adjusters or underwriters.

(iv) The only recoverable SIU expenses are for SIU's dedicated to investigation of insurance fraud within the State of California or for the portion of an SIU's operations within California. The burden of demonstrating the amount of SIU expenses, and that those expenses are for the investigation of insurance fraud within the State of California is the insurers.

(v) An insurer may recover the "Allocated Costs" of retaining an independent contractor to perform SIU services as described in sub-paragraph (iii). The variance shall be calculated by multiplying the fees paid for the independent agency with whom the insurer contracts by the percentage of referrals of claims made on the line of insurance for which the rate application and variance application are made and that the contracted agency investigates in California on behalf of the insurer seeking the variance.

(vi) No expense that is included within the Defense and Cost Containment Expense portion of an insurer's rate application can be included in whole or in part as the basis for a variance based on SIU expenses. The terms "Defense and Cost Containment Expense" or "DCCE" when used with regard to any variance have the same meaning as those terms have in section 2644.23(c).

(vii) An insurer that asserts that payments to: (1) an independent contractor; or (2) an SIU owned by an Affiliated Insurer; or (3) an SIU independent of an insurer, but which is owned directly or indirectly, in whole or part by the insurer applying for a variance or by an Affiliated Insurer, shall in its variance request, provide the Department of Insurance with documentation showing the costs of investigation for the purported "Allocated Costs" claimed in the variance request. The payments constituting the basis for the variance must be bona fide payments for investigation of individual cases of suspected insurance fraud. It shall be the burden of the insurer to demonstrate that the costs are bona fide costs for investigation of insurance fraud in the State of California.

(B) An insurer meeting the qualifications set forth below will be allowed to recover its expenses for the most recent year for dedicated loss prevention programs such as brush clearance, driver education, risk management, hazard mitigation or accident prevention. Loss prevention expenses do not include SIU expenses under subsection (A).

(i) An insurer may recover its "Allocated Costs" for its loss prevention expenses only in its approved rate for the line of insurance affected by the loss prevention expenses.

(ii) The insurer must provide documentation detailing the loss prevention program, what additional costs are being incurred and what losses are being prevented.

(iii) Recoverable loss prevention expenses are those expended for employees whose duties are loss prevention, software dedicated to loss prevention, and equipment to be used for loss prevention. Recoverable loss prevention expenses do not include the routine and customary costs of marketing or employing underwriters or adjusters.

(iv) The only loss prevention expenses recoverable are for loss prevention programs dedicated to loss prevention in the State of California or for the portion of the program within

California. The burden of demonstrating the amount of loss prevention costs, and that those costs are expended for loss prevention in the State of California is on the insurer.

(2) That the insurer should be allowed relief from the efficiency standard due to any or all of the following:

~~(A)~~ Higher quality of service, as demonstrated by objective measures of consumer satisfaction; or

~~(B)~~ (A) Demonstrated superior service to underserved communities, as defined in section 2646.6; or

~~(C)~~ (B) Significantly smaller or larger than average California policy premium, including any applicable fees. These fees include but are not limited to: policy fees, installment fees, endorsement fees, inspection fees, cancellation fees, reinstatement fees, late fees, SR-22, and other similar charges.

(3) That the insurer should be authorized leverage factor different from the leverage factor determined pursuant to section 2644.17 on the basis that the insurer either writes at least 90% of its direct earned premium in one line or writes at least 90% of its direct earned premium in California and its mix of business presents investment risks different from the risks that are typical of the line as a whole. The leverage factor shall be adjusted by multiplying it by 0.85. The surplus ratio in section 2644.22 shall likewise be divided by 0.85. If an insurer writes at least 90% of its direct earned premium in one line and writes at least 90% of its direct earned premium in California, the insurer will only be authorized one leverage factor adjustment of 0.85.

(4) That the insurer should be allowed a higher return on equity due to higher financial investment in underserved communities, as defined in section 2646.6.

~~(4)~~ (5) That the insurer should be granted relief from operation of the efficiency standard for a line of insurance in which the insurer has never previously written over \$ 1 million in earned premiums annually and in which the insurer has made or is making a substantial investment in order to enter the market. Any such request shall be accompanied by a proposed amortization schedule to distribute the start-up investment.

~~(5)~~ (6) That the minimum permitted earned premium should be lowered on the basis of the insurer's certification, and the Commissioner's finding, that the rate will not cause the insurer's financial condition to present an undue risk to its solvency and will not otherwise be in violation of the law.

~~(6)~~ (7) That the insurer's financial condition is such that its maximum permitted earned premium should be increased in order to protect the insurer's solvency. Any application for authorization under this subsection shall include:

(A) A showing of the insurer's condition, based on generally accepted standards such as the

National Association of Insurance Commissioners' Insurance Regulatory Information System;

(B) A plan to restore the financial condition;

(C) A showing that, consistent with the claimed condition, the insurer has reduced or foregone dividends to stockholders or policyholders; and

(D) A plan to reduce rates once the insurer's condition is restored, in order to compensate consumers for excessive charges.

~~(7)~~ (8) That the loss development formula in section 2644.6 does not produce ~~an~~ *the most* actuarially sound result because

(A) There is not enough data to be credible;

(B) There are not enough years of data to fully calculate the development to ultimate;

(C) There are changes in the insurer's reserving or claims closing practices that significantly affect the data; or

(D) There are changes in coverage or other policy terms that significantly affect the data; or

(E) There are changes in the law that significantly affect the data; or

(F) There is a significant increase or decrease in the amount of business written or significant changes in the mix of business.

~~(8)~~ (9) That the trend formula in section 2644.7 does not produce the most actuarially sound result because

(A) There is a significant increase or decrease in the amount of business written or significant changes in the mix of business;

(B) There are not enough years of data to calculate the trend factor;

(C) There is a significant change in the law affecting the frequency or severity of claims;

(D) It can be shown that a trend calculated over a period of at least 4 quarters other than a period permitted pursuant to section 2644.7(b) is more reliable prospectively;

(E) There are changes in the insurer's claims closing practices that significantly affect the data; or

(F) There are changes in coverage or other policy terms that significantly affect the data.

~~(9)~~ (10) That the maximum permitted earned premium would be confiscatory as applied. This

is the constitutionally mandated variance articulated in 20th Century v. Garamendi (1994) 8 Cal.4th 216 which is an end result test applied to the enterprise as a whole. *For purposes of this subdivision "enterprise as a whole" means the insurer's operations in all lines of insurance which are subject to this Article and which are conducted in California.* Use of this variance requires a hearing pursuant to 2646.4.

(g) If there is more than one actuarial analysis of a variance, each of which is based on reliable data and utilizes methods which are shown by qualified expert evidence to be generally accepted as sound by the actuarial community and the appropriate methods for the particular variance, then the variance shall be granted, denied or calculated utilizing the actuarial proposition that results in the soundest actuarial result.

(h) Notwithstanding any other section of these regulations, the aggregate total adjustment to the efficiency standard for all variances combined shall not exceed the difference between the insurer's most recent year total expense ratio excluding defense and cost containment expenses and the efficiency standard.

Note: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; and 20th Century v. Garamendi, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; and Calfarm Insurance Company v. Deukmejian (1989) 48 Cal.3d 805.

§ 2644.29 Implementation of Rate Changes

If a rate change approved pursuant to this article is greater than 15%, the Commissioner may order the change to be implemented incrementally over a period of not more than two years. The Commissioner may condition approval of incremental implementation pursuant to this section on the insurer's agreement to submit another rate application within a time period specified by the Commissioner.

Note: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; and 20th Century v. Garamendi, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; and Calfarm Insurance Company v. Deukmejian (1989) 48 Cal.3d 805.

CALIFORNIA CODE OF REGULATIONS
TITLE 10. INVESTMENT
CHAPTER 5. INSURANCE COMMISSIONER
SUBCHAPTER 4.8. REVIEW OF RATES
ARTICLE 4.5. REFILEING OR REDUCTION OF APPROVED RATES

§ 2644.50. Refiling of Approved Rates.

As a means to determine whether a rate previously approved remains in compliance with the statutory standard set forth in California Insurance Code Section 1861.05(a), for an insurer operating with a rate approved *pursuant to Article 4 of this subchapter* three years ago or

longer in the homeowners multiple peril and private passenger auto liability and physical damage lines, the Commissioner may require an insurer to file a rate application. *If the insurer is operating with a rate approved pursuant to section 2644.51, the Commissioner may require an insurer to file a rate application if the rate has not been approved pursuant to Article 4 of this subchapter for three or more years.*

Nothing in this section shall be construed to specify how often an insurer may make a rate application filing.

§ 2644.51. Reduction of Approved Rates

(a) Notwithstanding Article 4 of this subchapter, any insurer desiring to reduce an approved rate may do so by filing an Application to Reduce Rates, on a form established by the Commissioner. The Application to Reduce Rates shall include all the information required for a complete rate application by section 1861.05 of the Insurance Code. An Application to Reduce Rates shall be deemed approved, as submitted, 60 days after the complete application is received by the Commissioner unless the Commissioner within those 60 days orders a hearing on the application pursuant to section 1861.05 of the Insurance Code.

(b) A rate reduction pursuant to this section may be made only on the basis of the insurer's certification, and the Commissioner's finding, that the rate will not cause the insurer's financial condition to present an undue risk to its solvency and will not otherwise be in violation of the law.

(c) Nothing in this section shall restrict the Commissioner's authority to initiate a proceeding against an insurer's use of a rate that is excessive, inadequate, or unfairly discriminatory in violation of 1861.05 of the Insurance Code.

(d) An Application to Reduce Rates may not be submitted pursuant to this section for a rate change in any homeowners multiple peril and private passenger auto liability and physical damage rate which could be subject to an order by the Commissioner pursuant to section 2644.50.

Note: Authority cited: Sections 1857.2, 1857.3, 1861.01, 1861.05 and 12921, Insurance Code; and 20th Century v. Garamendi, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; and Calfarm Insurance Company v. Deukmejian (1989) 48 Cal.3d 805.