



Formerly The Foundation for Taxpayer & Consumer Rights

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Via E-Mail Transmission and Overnight Mail

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Re: OAL File No. 2008-506-01EFP, Proposed Changes to Prior Approval Regulations set forth in Title 10, California Code of Regulations, Subchapter 4.8, Sections 2642.6 – 2644.27, CDI File No. REG-2007-00046

Dear Director Lapsley:

Pursuant to Government Code section 11349.6(b) and California Code of Regulations, title 1, section 55, Consumer Watchdog¹ urges the Office of Administrative Law (OAL) to disapprove the above-referenced proposed emergency regulations as filed by the Insurance Commissioner with OAL on May 6, 2008 to amend Title 10, California Code of Regulations (“CCR”), Subchapter 4.8, Sections 2642.6 – 2644.27, which govern the prior approval of the rates of all property-casualty insurers (“Rate Regulations”). The proposed amendments to the Rate Regulations fail to comply with Government Code section 11349.6 that would allow their adoption without the full public scrutiny required under the Administrative Procedure Act (APA) when the Commissioner has failed to identify any “situation that calls for immediate action *to avoid serious harm to the public peace, health, safety, or general welfare.*”²

Commissioner Poizner has failed to come close to demonstrating any harm to the public that would justify the adoption of substantial amendments to the Rate Regulations on an “emergency” basis. His two-page explanation of the “emergency” is full of unsubstantiated and vague allusions to the difficulty the industry and the California Department of Insurance (CDI) will face if the proposed changes are not made right away. It also never describes how the proposed regulations will actually address the alleged “emergency.”

Indeed, there is no emergency here. As Commissioner Poizner acknowledges, amendments to the regulations he wishes to change now became effective in April 2007 after two years of public scrutiny, analysis and hearings. CDI staff has been enforcing the current regulations for over a year,

¹ Formerly: The Foundation for Taxpayer and Consumer Rights.

² Gov. Code § 11342.545 (defining “emergency”).

and rate applications of over a thousand companies have been processed without problem. If there were flaws in the current regulations, Commissioner Poizner could have and should have addressed them months ago through the regular rulemaking process. And many of the changes he proposes – affecting homeowners, earthquake and even medical malpractice insurance rates – have nothing to do with the July 2008 deadline for compliance with auto rating factor (“ARF”) regulations, as referenced by the Commissioner, which has been known to the CDI for two years.

Because the Commissioner has failed to demonstrate an emergency, and because there is no emergency, OAL is required by law to reject the proposed emergency regulations.

Not only do the Commissioner’s proposed regulations fail to demonstrate the requisite “emergency,” but they also fail to meet the “clarity” and “necessity” standards for valid regulations. For example, as discussed further below, rather than providing “better defined benchmarks”, several of the proposed amendments introduce a “definition” of “most actuarially sound” that will undoubtedly be subject to more than one interpretation by insurers, the CDI, and consumer representatives that must be able to understand and apply the terms in rate proceedings. Other provisions have introduced completely undefined terms that are incomprehensible to the insurers and consumers directly affected by them.

Finally, far from demonstrating any “necessity” for any one of the proposed revisions with the requisite “facts, studies, and expert opinion”, the Commissioner merely states that the proposed amendments purportedly represent “revisions to the prior approval regulations which were not able to be addressed in the 2007 revisions.” While he refers to the proposed amendments as “necessary changes,” the Commissioner never identifies a single provision of the proposed amendments and explains why it is necessary to effectuate the purpose of Insurance Code section 1861.05 of ensuring that rates are not “excessive, inadequate, unfairly discriminatory, or otherwise in violation of [Proposition 103].”

BACKGROUND OF PRIOR APPROVAL RATE REGULATIONS

Proposition 103 and the Adoption and Implementation of Prior Approval Regulations

The prior approval system of rate regulation under Proposition 103 adopted by the voters in 1988 requires insurers to apply for and obtain approval for rate changes from the Insurance Commissioner and that the rates set cannot be excessive, inadequate, or unfairly discriminatory. (Ins. Code §§ 1861.01(c) and 1861.05.)

In 1991, Commissioner Garamendi adopted regulations to implement the rollback and prior approval rate provisions of Proposition 103 (California Code of Regulations, Title 10, Chapter 5, Subchapter 4.8, §§ 2642.1, et seq.) These regulations were upheld in 1994 by the California Supreme Court in *20th Century v. Garamendi* (1994) 8 Cal.4th 216, 243, cert. den. *State Farm Mut. Auto. Ins. Co. v. Quackenbush* (1995) 513 U.S. 1153.) The basic regulatory rate formulae (10 CCR §§ 2644.2 and 2644.3) that have been used to review and approve rate applications in California,

resulting in over \$60 billion in savings in just the automobile insurance line alone over the last 17 years,³ have remained largely unchanged ever since.

2007 Rate Regulations Amendments Adopted Pursuant to APA Rulemaking Requirements

Commissioner Garamendi commenced formal rulemaking proceedings (CDI File No. RH05042749) in 2005 to adopt methodologies and values for certain components of the Rate Regulations, that were left unpromulgated in the 1995 regulations. During the period leading up to these proposed amendments, the 1995 regulations were applied to review and approve rate applications both with and without hearings.⁴ After numerous public workshops, public comment, and a formal public hearing were held on various draft amendments held over a two-year span following the formal rulemaking requirements of the APA, amendments to the Rate Regulations were adopted effective April 3, 2007.⁵ The 2007 amendments established uniform methodologies and values for various components of the regulatory formula such as loss trend, expense efficiency standard, rate of return, and leverage ratio (limiting surplus used to calculate profit), which are to be used to ensure that rates filed by insurers are not excessive under the prior approval requirements of Proposition 103. (See, e.g., 10 CCR §§ 2644.7, 2644.12, 2644.16, and 2644.17.) The 2007 amendments also established additional “safety valves” for insurers to seek exceptions to a strict application of the rate formulae, known as “variances”. (10 CCR § 2644.27.) Since the adoption of the 2007 amendments, over 1,000 rate applications have been filed and reviewed.⁶ Of these, 34%

³ Consumer Federation of America, J. Robert Hunter, State Automobile Insurance Regulation: A National Quality Assessment and In-Depth Review of California’s Uniquely Effective Regulatory System (Apr. 2008) Appendix 4, Spreadsheet 13 (“Estimate of Savings from Proposition 103”) available online at <http://www.consumerfed.org/publications2.cfm?type=studies>.

⁴ In a 2003 decision designated as precedential, Commissioner Garamendi confirmed that the regulatory ratemaking formula (10 CCR § 2644.1, et. seq.) must be applied by the Department when reviewing rate applications even in the absence of certain components that were left undefined, explaining as follows:

...where the Commissioner has not promulgated a numerical value for a generic factor in a given line of insurance, values can be selected using generally accepted actuarial principles, expert judgment and standards of reasonableness. Barring explicit direction from the Legislature or the commissioner, the ALJ must apply the regulatory formula when determining whether SCPIE’s rate request is reasonable. SCPIE has not provided authority for ignoring the regulations in the face of their clear legal applicability.

(*In re American Healthcare Indemnity Company, et. al.*, File No. PA-02025379, Proposed Decision, filed July 24, 2003, p. 8; Corrected Order Adopting Proposed Decision and Designating Portion of Decision as Precedential, filed August 22, 2003, p. 1.)

⁵ Office of Admin. Law, Cal. Reg. Notice Register, Jan. 19, 2007, p. 98 (http://www.oal.ca.gov/notices/January2007_notice_pdf.htm).

⁶ See CDI website for yearly lists of rate filings: <http://www.insurance.ca.gov/0250-insurers/0800-rate-filings/0100-rate-filing-lists/public-notices/index.cfm>.

have sought rate decreases.⁷ The most significant rate reduction under the 2007 regulations, which was ordered after a public hearing in which Consumer Watchdog played a significant role as Intervenor, was a 15.9% rate reduction to Allstate's private passenger automobile rates amounting to a quarter-billion dollars in savings to Allstate auto policyholders.⁸ These facts belie the Commissioner's implication that "auto rate changes to be implemented via the ARF filings will not occur in harmony" because many auto insurers have already reduced their rates under the 2007 amendments over the last year.

Proposed 2008 "Emergency" Amendments

The day before the 2007 amendments to the Rate Regulations went into effect, the CDI issued a notice on April 2, 2007 inviting public comment solely on the eleven "variances" contained in 10 CCR § 2644.27. That notice stated that "[t]he Department specifically intends to address the evidence required for and the effect of each variance." (See Exh. A, Notice of Informal Workshop Regarding Variances Set Forth in Title 10, California Code of Regulations, Section 2644.27, CDI File No. REG-2007-00023, April 2, 2007.) No notice of any proposed text of amendments being considered by the CDI was circulated at that time.

After the one-day workshop regarding the variance regulation, 10 CCR § 2644.27, held on April 2, 2007, no further action was taken by the CDI until October 29, 2007. On that date, the CDI Deputy Commissioner of the Rate Regulation Branch issued a one-page letter stating that "[t]he CDI is currently reviewing the eleven variances associated with the Prior Approval Regulations (California Code of Regulations, Title 10, Section 2644.27)." (Exh. B, Letter from Sherwood P. Girion to "Interested Persons" regarding the Variance Process, Oct. 29, 2007.) That letter further stated that "I am concerned that the variances as currently written may need some amendment to operate as intended, to provide appropriate standards for granting or denying specific variances, and to provide sufficient instruction regarding what information or data to submit when an insurer is applying for a specific variance." The letter invited comments "with regard to any of the variances." No proposed text of any amendments under consideration by the CDI was circulated to the public with the October 29, 2007 letter and no date was noticed for any public workshop or hearing.

No further action was taken by the CDI until March 19, 2008 when it issued a notice of a public workshop to be held on April 7, 2008 to discuss not only changes to the variances, but also "other changes to Title 10, Subchapter 4.8, Section 2642.6 – 2644.27." (Exh. C, Notice of Informal Workshop Regarding Potential Changes to Prior Approval Regulations Set Forth in Title 10, California Code of Regulations, Sections 2642.6-2644.27, CDI File No. REG-2007-00046, Mar. 19, 2008.) This was the first time that the CDI gave any notice to the public that it was considering changes to the Rate Regulations beyond just the variance regulation in 10 CCR § 2644.27 to include major substantive revisions to the regulatory rate formula in sections 2642.6-2644.25. This was also the first time that the CDI actually provided the text of the proposed amendments under consideration to the public. (Exh. C, Proposed Changes To The Prior Approval

⁷ *Ibid.*

⁸ Order Adopting Proposed Decision, *In the Matter of the Rate Application of Allstate Insurance Co. and Allstate Indemnity Co.*, PA-2007-00004, Mar. 14, 2008.

Regulations Set Forth in Title 10, California Code Of Regulations, Subchapter 4.8 Sections 2642.6 – 2644.27, CDI File No. REG-2007-00046, Mar. 19, 2008.) The notice specifically stated that “*participation in the workshop will be in addition to, and not in substitution for, any participation in a formal rulemaking process.*” *There was no mention in the Notice of Workshop of adopting the proposed amendments as “emergency regulations.”*

On April 21, 2008, the CDI issued a “Notice of Proposed Emergency Action and Finding of Emergency Pursuant to California Insurance Code Section 12921.7” along with proposed text that included further substantive amendments to the provisions of the rate formula that were never before seen by the public in the March 19 draft. (Exh. D, Notice Of Proposed Emergency Action and Finding of Emergency Pursuant to California Insurance Code Section 12921 and Proposed Changes To The Prior Approval Regulations Set Forth in Title 10, California Code Of Regulations, Subchapter 4.8 Sections 2642.6 – 2644.27, CDI File No. REG-2007-00046, Apr. 21, 2008.) No public comment period or hearing was provided on this version of the amendments. This was the first time that the CDI mentioned that the ARF filing deadline of July 14, 2008 was suddenly an “emergency”.

On April 29, the CDI issued yet another version of the proposed regulations, again as a notice of “emergency” action, which contained even more substantive changes to additional provisions of the regulations that had never before been presented to the public. (Exhibit E, Notice Of Proposed Emergency Action and Finding of Emergency Pursuant to California Insurance Code Section 12921 and Proposed Changes To The Prior Approval Regulations Set Forth in Title 10, California Code Of Regulations, Subchapter 4.8 Sections 2642.6 – 2644.27, CDI File No. REG-2007-00046, Apr. 29, 2008.) No hearing or public comment opportunity was provided for the April 29 proposed amendments.

The CDI filed the April 29 version of the proposed amendments, including the provisions on which no public comment was ever solicited, with OAL on May 6, 2008. (Proposed Text, CDI File No. REG-2007-00046, May 5, 2008.) Accompanying the proposed text was a document entitled “Finding of Emergency”, which proclaims that “California Insurance Commissioner Steve Poizner (the “Commissioner”) hereby finds that an emergency exists, and that the following amendments to the Prior Approval Regulations...are necessary for the immediate preservation of the public peace, health and safety, or general welfare.” (“Finding of Emergency”, CDI File No. REG-2007-00046, May 5, 2008.) (hereafter “Emergency Notice”)

I. ADOPTION OF THESE REGULATIONS IS NOT NECESSARY FOR “IMMEDIATE PRESERVATION OF PUBLIC PEACE, HEALTH AND SAFETY, OR GENERAL WELFARE.”

The “justification” provided by the Commissioner in the Emergency Notice utterly fails to meet the requisite showing for adoption of a regulation as an “emergency” as “a situation that calls for immediate action *to avoid serious harm to the public peace, health, safety, or general welfare*”

(Gov. Code § 11342.545) and fails to meet the requirements of Government Code section 11346.1⁹ on three separate grounds. First, the Commissioner's written submission fails on its face to set forth any facts showing the need for immediate action. Secondly, the complete procedural history of these regulations, as set forth above, demonstrates the Commissioner's and the CDI's own belief that no emergency exists. Thirdly, the substance of the proposed emergency regulations reveals the lack of any immediate threat to "public peace, health and safety or general welfare."

The Commissioner claims that the "emergency" is a July 14, 2008 deadline applicable only to private passenger automobile insurers to comply with another set of Proposition 103 regulations, which took effect on August 13, 2006.¹⁰ Those regulations govern the weighting of the factors that auto insurers use to determine individuals' premiums pursuant to Insurance Code section 1861.02

⁹ Gov. Code § 11346.1(b) provides, in pertinent part:

(2) Any finding of an emergency shall include a written statement that contains the information required by paragraphs (2) to (6), inclusive, of subdivision (a) of Section 11346.5 and a description of the specific facts demonstrating the existence of an emergency and the need for immediate action, and demonstrating, by substantial evidence, the need for the proposed regulation to effectuate the statute being implemented, interpreted, or made specific and to address only the demonstrated emergency. The finding of emergency shall also identify each technical, theoretical, and empirical study, report, or similar document, if any, upon which the agency relies. The enactment of an urgency statute shall not, in and of itself, constitute a need for immediate action.

A finding of emergency based only upon expediency, convenience, best interest, general public need, or speculation, shall not be adequate to demonstrate the existence of an emergency. If the situation identified in the finding of emergency existed and was known by the agency adopting the emergency regulation in sufficient time to have been addressed through nonemergency regulations adopted in accordance with the provisions of Article 5 (commencing with Section 11346), the finding of emergency shall include facts explaining the failure to address the situation through nonemergency regulations. (Emphasis added.)

¹⁰ As amended effective August 13, 2006, 10 CCR § 2632.11(c)(1) required auto insurers to submit at least two filings to comply with the 2006 amendments to 10 CCR § 2632.8. The first was to be filed "within 30 days of the date the 2006 amendments to Section 2632.8 are filed with the Secretary of State." The 2006 amendments to sections 2632.8 and 2632.11 were filed with the Secretary of State on July 14, 2006 and became effective on August 13, 2006. (Office of Admin. Law, Cal. Reg. Notice Register, July 28, 2006, p. 1055 [http://www.oal.ca.gov/notices/July2006_notice_pdf.htm].) Thus the first filing to at least partially comply with the 2006 amendments to section 2632.8 was to be filed by August 13, 2006. Insurers are required to "fully comply with Section 2632.8 within two years of the date of the 2006 amendments to Section 2632.8 are filed with the Secretary of State." (10 CCR § 2632.11(c)(1).) Thus the second filing is required to be made by auto insurers July 14, 2008.

(“ARF regulations”). (See 10 CCR §§ 2632.8 and 2632.11.) ***The proposed emergency regulations do not amend any provision of the ARF regulations.*** Courts have stated that an “emergency” means “an *unforeseen* situation calling for immediate action.” (*Sonoma County Organization Employees v. County of Sonoma* (1991) 1 Cal.App.4th 267, 276-277.) Far from being “unforeseen”, the July 14, 2008 ARF filing deadline has been known by the California Department of Insurance (CDI) for at least two years since the ARF regulations were filed with OAL on June 5, 2006. These facts alone warrant disapproval by OAL because “a finding of emergency based only upon expediency, convenience, best interest, general public need, or speculation, shall not be adequate to demonstrate the existence of an emergency” (Gov. Code § 11346.1(b)(2)). Moreover, the Commissioner has not explained his utter failure to address the situation through nonemergency regulations when the claimed emergency “was known by the [CDI] in sufficient time to have been addressed through nonemergency regulations.” (*Ibid.*) This manufactured “emergency” of the Commissioner’s own making cannot justify adoption of the proposed regulations, several provisions of which were publicly noticed for the first time on April 29 and have not been the subject of any public comment whatsoever.

A. The Commissioner’s Notice Fails to Set Forth Any Facts Showing Any Need For Immediate Action.

In *Poschman v. Dumke* (1973) 31 Cal. App.3d 941, 944, the Court of Appeal set forth minimal standards for considering emergency regulations under the APA: “[t]he finding of and statement of facts constituting an emergency must be more than mere ‘statements of the motivation’ for the enactment” (citation omitted). The Commissioner’s Emergency Notice cannot meet this test. The “Justification for Adoption as Emergency Regulations” section ignores the *Poschman*’s court warning by baldly asserting “[t]hese regulations need to be enacted on an emergency basis in order to have a fully functioning regulatory scheme.” (Emerg. Not. at 2.) This bare assertion, however, does not explain with any facts why the current regulatory scheme is “not fully functioning.” Even if this statement were true, this reason fails entirely to meet the requisite showing that the amendments must be adopted on an emergency basis so as to avoid serious harm to the public.

The fact is, however, that there is already a fully functioning regulatory scheme in place. Even prior to the 2007 amendments, as noted above and in the Emergency Notice, the rate formulae in the Rate Regulations were upheld by the California Supreme Court in *20th Century* in 1994. Over the course of the 14 years since, the current regulations have been applied to review and approve rate applications and resulted in over \$55 billion in savings to consumers in the auto line alone.¹¹ For example, in the time period for 2003 – 2007, Consumer Watchdog intervened in 20 rate proceedings where the Rate Regulations have been applied to result in over \$800 million savings to consumers.¹² Since the 2007 amendments, which further defined the methodologies and values to be used in the regulatory rate formulas, the CDI has processed over 1000 rate applications, at least 34% of which

¹¹ See, *supra*, footnote 3.

¹² See Consumer Watchdog, CA Prop 103 Savings in Insurance Premiums 2003-2007 (<http://www.consumerwatchdog.org/images/InsSavings.gif>).

have sought further rate decreases.¹³ There have been at least five rate hearings held under the 2007 regulations, and so far, one of these has led to a final order of the Commissioner requiring Allstate to reduce its auto rates by 15.9%.¹⁴ There is no mention in the decision by the ALJ or the Commissioner in that case that the current regulations do not provide a “fully functioning regulatory scheme.” As stated in the Emergency Notice, “the 2007 revisions were intended to simplify the prior approval process and to provide some flexibility in certain situations as warranted by the variances.” (Emerg. Not. at 2.) Even if some amendments were needed to “resolve issues with the variances as well as to address other issues that arose after the 2007 revisions” (*ibid.*), that is not a situation that rises to the level of an “emergency” that would warrant allowing the CDI to avoid subjecting the proposed regulations to the requisite public notice and comment requirements for nonemergency regulations pursuant to Government Code section 11346.2, et seq.

The Emergency Notice also asserts that “[t]he Commissioner must utilize the emergency regulations procedures; otherwise the coverage and rate changes to be implemented via the ARF filings will not occur in harmony with rate changes resulting from these revisions.” (Emerg. Not. at 3.) The Notice goes on to claim, without any basis in fact, that “requiring insurers to file two rate filings, one right after another would cause tremendous confusion in the marketplace.” (*Ibid.*) There is no reason given as to why insurers would be required to “file two rate filings”. Even if the proposed amendments were to be adopted on a nonemergency basis after the current ARF filing deadline passes, there is no reason why companies would be required to make a new filing after those amendments take effect unless the Commissioner determines that the rates as enacted under the current 2007 Rate Regulations are excessive or inadequate under the proposed amendments. The Notice does not say that this will happen. Even if it were to happen, the Notice fails to explain or provide any evidence that preventing an insurer from having to make another rate filing sometime later in 2008 that would likely not be implemented until 2009, rises to the level of an “emergency.”

The Emergency Notice cites to just one appellate court case, *Schenley Affiliated Brands Corp. v. Kirby* (1971) 21 Cal.App.3d 177, to support its contention that the proposed amendments need to be adopted on an emergency basis. The Emergency Notice states that the court held there that the agency did not abuse its discretion in adopting emergency regulations “where other regulations were about to go into effect and additional regulations were needed in order to achieve a fully operational regulatory scheme.” (Emerg. Not. At 3.) *Schenley* is inapposite for at least two reasons. First, in *Schenley*, the “other regulations” that were about to take effect were part of the *same* regulatory scheme as the proposed emergency regulations and the agency claimed that the emergency regulations clarified the regulations that were about to go into effect. Here, the ARF regulations are not part of the same regulatory scheme as the proposed emergency amendments. The filings that are subject to the ARF regulations are reviewed and approved under separate substantive and procedural standards than are rate applications that are subject to the prior approval Rate Regulations. (Compare 10 CCR §§ 2632.1-2632.11 [substantive and procedural requirements applicable only to private passenger automobile insurers regarding the factors used to determine individual drivers’ premiums] with 10 CCR §§ 2642.1-2644.27 [Rate Regulations at issue here applicable to all insurers subject to Proposition 103]; §§2648.1-2648.4 [procedural regulations

¹³ See, *supra*, footnote 6.

¹⁴ See, *supra*, footnote 8.

applicable to rate applications].) Second, even if the ARF regulations were considered to be part of the same regulatory scheme as the prior approval Rate Regulations, unlike the situation in *Schenley* where new regulations were about to take effect, the ARF regulations have been in effect since August 13, 2006.¹⁵ While the 2006 amendments to the ARF regulations provided for two stages of compliance, the first phase has already occurred whereby private passenger auto companies were required to make ARF filings and rate filings by August 13, 2006 that came into at least partial compliance with the ARF regulations by that date. (10 CCR § 2632.11(c)(1)-(4).) Indeed, the Emergency Notice states that 20% of private passenger automobile insurers have already complied with the ARF deadline. (Emerg. Not. at 3.) The rate filings submitted by private passenger auto companies that complied with the 2006 ARF deadline were reviewed and approved under the regulatory rate formula that existed prior to the 2007 amendments that “simplif[ied] the prior approval process” even further. Thus, these facts directly contradict the Commissioner’s statements that the amendments need to be adopted on an emergency basis to make the current regulatory scheme “fully operational.”

The Emergency Notice further asserts, without any reference to any specific provisions of the proposed regulations, that “[t]he amendments are necessary prior to the ARF filing deadline to allow the Department to handle the large number of filings anticipated.” (Emerg. Not. at 3.) The Notice states that “only about twenty percent of private passenger automobile insurers have complied with the ARF deadline which means an influx of filings which the Department will have to review within the statutorily prescribed time frame of 60 days.” (*Ibid.*) This also does not constitute an emergency. Regardless of whether the proposed amendments are adopted on an emergency basis, the CDI will still have to review and approve filings of 80% of all private passenger auto companies, and the regulations will not lessen the number of filings that will need to be reviewed.

Finally, the CDI claims that “the revised regulations provide clarity with better defined benchmarks and will make the development and submission of the ARF filings less cumbersome and time consuming for both insurers and the Department.” (*Ibid.*) Regardless of whether this is true or not, this too does not rise to the level of an “emergency.” At most, this amounts to a claim that the new regulations will result in a more expedient rate review process. Even if true, the Government Code explicitly states that “a finding of emergency based only upon expediency, convenience, best interest, general public need, or speculation shall not be adequate to demonstrate the existence of an emergency.” (Gov. Code § 11346.1(b)(2).) Moreover, “[i]f the situation identified in the finding of emergency existed and was known by the agency adopting the emergency regulation in sufficient time to have been addressed through nonemergency regulations adopted in accordance with Article 5 (commencing with Section 11346), the finding of emergency shall include facts explaining the failure to address the situation through nonemergency regulations.” (*Ibid.*) The CDI has been aware of the so-called “emergency” of the 2008 ARF filing deadline since at least when the ARF regulations were filed with the Secretary of State on June 5, 2006. The 2007 amendments to the rate regulations took effect on April 7, 2007. The CDI gives no explanation of why it could not have noticed the proposed amendments sometime within the last year to adopt them on a nonemergency basis in accordance with public notice and comment provisions of Article 5 in sufficient time before

¹⁵ See, *supra*, footnote 10.

the second July 14, 2008 ARF compliance deadline. Accordingly, the CDI has failed to comply with the requirements of Government Code § 11346.1(b)(2).

In sum, none of the reasons listed in the Emergency Notice constitute a situation that requires immediate action “to avoid serious harm to the public peace, health, safety or general welfare” and thus the OAL must reject the proposed “emergency” regulations.

B. The Procedural History Amply Demonstrates the Complete Absence of Any Threat to “Public Peace, Health and Safety, or General Welfare.”

The procedural history of these regulations recited above, reveal the Commissioner’s lack of belief that any state of emergency threatening the general welfare existed regarding the July 14, 2008 ARF filing deadline. As stated above, this filing deadline has been known to the CDI since at least June 5, 2006 when the final ARF regulations were filed with OAL. Yet apparently, from that time until April 21, 2008 when he first issued a Notice of Emergency Action, the Commissioner did not believe an emergency existed that would justify adoption of emergency regulations. While the Commissioner informed the public that there were issues with the variance regulation that needed to be addressed and issued notices to that effect in April 2007 and November 2007 inviting public comment on that one regulation, 10 CCR § 2644.27, those notices made no mention of any “emergency” that needed to be addressed by changes to other substantive provisions to the Rate Regulations that were not noticed for public comment at those times. Even though the Emergency Notice claims that “the proposed regulation changes are a result of several months of study, discussion and refinement,” it wasn’t until April 21, 2008 that the public was first informed that the July 14, 2008 ARF filing deadline was suddenly an “emergency” requiring the wholesale substantive revisions to sections 2642.2-2644.25 noticed for the first time on April 21. Consumer Watchdog respectfully submits that it is impossible under these circumstances to suddenly create a state of emergency out of a deadline under a different set of regulations applicable only to private passenger automobile insurance companies that has been known by the CDI for over two years. These facts create the inescapable inference that the Commissioner’s filing of these “emergency” regulations was intended solely to avoid public scrutiny of the proposed amendments to the Rate Regulations that were never before noticed for public comment over the entire one-year period from April 2007 to April 2008 during which the CDI was holding public discussions regarding only the variance regulation.

Approval of these regulations would make a mockery of the APA and set a dangerous precedent for future rulemaking by administrative agencies. An approval by OAL would open the door for agencies to create an “emergency” out of known deadline requirements of other existing regulations, secretly develop regulations without allowing an opportunity for public comment, and then delay filing the regulations with OAL until it was “too late” to comply with the APA. Such undercover “bait and switch” rulemaking to deal with a so-called “emergency” of the Commissioner’s own making should be firmly disapproved by OAL.

C. Many of the Proposed Emergency Regulations Do Not Even Apply to Auto Insurance, Which is the Only Line that is Subject to the So-Called ARF Filing Deadline “Emergency.”

The substance of the proposed emergency regulations belies the existence of any emergency.

Even if the influx of automobile insurance rate and ARF filings due this summer could somehow justify hasty changes in the regulations that apply to auto insurance rates, there is absolutely no basis to amend on an “emergency” basis several provisions of the regulations that have ***absolutely no application to auto insurers***. For example the proposed changes to 10 CCR § 2644.27(d), (f), (i) and (j) governing reinsurance to allow higher amounts of unregulated reinsurance costs to be passed through to policyholders’ rates ***only apply to companies selling earthquake and medical malpractice insurance***. (10 CCR § 2644.25(b).) Auto rates are calculated on a direct basis with no allowance for reinsurance costs (10 CCR §§ 2644.2; 2644.25(a)), and thus are not subject to the alternative methodology for calculating rates for the earthquake and medical malpractice lines.

Several other proposed amendments to sections 2642.6-2644.25 likewise ***have no application auto insurers***. (See, e.g., proposed 10 CCR §§ 2642.7(a)(18) [relating solely to surety insurance], (d)(4)(M), (N), and (O) [relating solely to surety, credit, and aviation]; 2644.8 [applicable only to “professional liability and errors and omissions coverage”]; 2644.12(d) [applying solely to farmowners insurance], (e) [applying solely to earthquake insurance], and (f) [applying solely to burglary and theft insurance]; 2644.21(c) [applying solely to burglary and theft]; 2644.23 [applying solely to earthquake and medical malpractice insurers subject to 2644.25]; 2644.25(a), (b), (d), (f), (h), and (i) [applying only to earthquake and medical malpractice insurers per 2644.25(b)].) Because none of these provisions even apply to the auto insurers who must meet the July 14 ARF filing deadline, the Commissioner cannot meet the requisite showings that the proposed regulation “address only the demonstrated emergency” (Gov. Code § 11346.1(b)(2)) and “that the immediate adoption of the proposed regulation by the rulemaking agency can be reasonably expected to prevent or significantly alleviate that serious harm” that would occur if the Commissioner failed to adopt the proposed regulations on an emergency basis (1 CCR § 50(a)(5)(B)2.). The proposed amendments that have absolutely no application to auto insurers go far beyond “address[ing] only the [purported] emergency” of a filing deadline that applies only to auto insurers and thus will do nothing to “prevent or significantly alleviate” any serious harm that may occur due to the July 14 ARF filing deadline. (See Gov. Code § 11346.1(b)(2); 1 CCR § 50(a)(5)(B)2.) As a result, “OAL shall not approve any emergency regulation” that fails to comply with these requirements. (See 1 CCR § 50(a)(5)(B)2; see also Gov. Code § 11349.6 [“The office shall disapprove the emergency regulations ...if it determines that the agency failed to comply with Section 11346.1”].)

II. THE PROPOSED EMERGENCY REGULATIONS FAIL TO MEET THE STANDARDS OF GOVERNMENT CODE SECTION 11349.1.

Government Code Section 11349.1 contains standards for necessity, authority, clarity,

consistency, reference, and nonduplication, which all proposed regulations must meet in order to obtain OAL approval. Government Code section 11349.6(b) specifically applies those standards to emergency regulations. The emergency regulations here fail to meet the basic standards of clarity and necessity.¹⁶

A. The Proposed Regulations Fail to Meet the “Clarity” Standard.

The “clarity” standard requires that proposed regulations be “easily understood by those persons directly affected by them.” (Gov. Code § 11349(c).) In this case, those persons include insurers, the Commissioner, and consumers and their representatives (who have a right to intervene and challenge the approval rate applications). Many portions of the proposed emergency regulations fail the clarity test.¹⁷

Rather than “provid[ing] clarity with better defined benchmarks” as claimed by the Commissioner, the proposed amendments introduce poorly drafted “definitions” and “standards” that will only serve to inject the very confusion and delay into the rate setting process that the Commissioner purports to avert. For example, the proposed “emergency” amendments add an incomprehensible definition of “most actuarially sound” that will be the subject of endless debate over what it actually means. Proposed 10 CCR § 2642.8 reads:

The “most actuarially sound” choice is the most appropriate choice within the range of permissible actuarially sound choices, considering both the relative likelihood of all choices within the range and the context in which the choice will be employed.

This proposed definition cannot meet the “clarity” standard contained in Government Code section 11349.1(a)(3). How will it be determined what is “the most appropriate choice within the range of permissible actuarially sound choices”? Without any meaningful objective criteria to determine the “most appropriate choice,” the CDI, insurers, and consumer advocates will be left to argue as to what the “most appropriate choice” is and Administrative Law Judges in contested rate hearings will have absolutely no guidance as to how to choose amongst the parties’ proffered positions. Such a vague and meaningless definition will result in the very “*standardless, ad hoc decision making*” decried by the California Supreme Court in *20th Century Insurance Co. v. Garamendi* (1994) 8 Cal.4th 216, 312. The impact of this lack of “clarity” to the new definition of “most actuarially sound” is multiplied many times over as it has been inserted into several other provisions of the proposed regulations. (See, e.g., proposed section 2644.7(b) and (d) [containing the “actuarially sound” standard]; 2644.8

¹⁶ Although we limit our discussion here to the “necessity” and “clarity” standards, this should not be taken to mean that Consumer Watchdog believes that the amendments are “consistent” with Proposition 103.

¹⁷ This is not intended to be an exhaustive discussion of all the proposed provisions that fail to meet the “clarity” standard.

[same]; 2644.23 [referring to “actuarially sound” standard]; 2644.27(f)(8) [referring to the unclear standard: “the most actuarially sound result”, (g) [referring to “soundest actuarial result”].

Another provision that utterly fails to meet the “clarity” standard is newly added subdivision (c) of section 2644.16 that purports to allow the Commissioner to adjust the maximum allowable rate of return by 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.” There is absolutely no measure provided of what would be “significantly different”. It is also unclear as to over what time period the “historical average” is to be calculated that would be compared to the “difference between the risk-free rate and the cost of capital.” The term “cost of capital” is also undefined in the proposed regulations. Again, this complete lack of clarity will inject uncertainty and confusion into the interpretation and application of the standard for the maximum permitted rate of return that is currently clear to all parties under subdivision (a).

B. The Proposed Regulations Fail to Meet the “Necessity” Standard.

The “necessity” standard requires that “the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, ... 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 opinion.” (Gov. Code § 11349(a).)

The section of the Emergency Notice titled “Description of Problem and Necessity for Regulation” fails to discuss any facts, studies, or expert opinion as to why any of the proposed amendments are “necessary” to effectuate the purpose of Insurance Code section 1861.05, which is to prohibit rates that are “excessive, inadequate, unfairly discriminatory, or otherwise in violation this chapter.” The only justification for the changes provided is that “certain issues were identified both by the Department and insurers with regard to the administration of the variances” and that after these unspecified “issues” were identified, “the Department invested considerable time and effort in the development of standards and benchmarks and other revisions to the prior approval regulation which were not able to be addressed in the 2007 regulations.” (Emerg. Not. at 2.) There is absolutely no explanation in the Emergency Notice by reference to any facts, studies, or expert opinion of what these “issues” were or how the proposed changes will address them. In fact, the Commissioner summarily concludes that “the goal of this rulemaking is to make necessary changes to the variances and other associated prior approval regulations.” This only further begs the question of why are the proposed changes “necessary”?

Because the Commissioner has not identified any substantial evidence for any of the proposed amendments, there is no way for OAL to determine whether they actually address the generalized allegations in the Emergency Notice that the revisions will provide “better defined benchmarks and will make the development and submission of the ARF filings less cumbersome and time consuming for both insurers and the Department.” In fact, these generalized allegations are directly contradicted by other statements in the Notice noting that the current regulations were

upheld in *20th Century*, and that “all the sections work together to help determine an appropriate insurance rate, that is, one that is neither excessive nor inadequate.” (Emerg. Not. At 1.)

Furthermore, as discussed above, certain of the proposed regulations fail to satisfy the clarity standard. This failure also dooms the regulations under the necessity standard. The vagueness of these regulations means that they are extremely unlikely to meet their stated goal of making the submission of ARF filings less cumbersome. Moreover, as stated above, agencies should not be able to manufacture the “necessity” for emergency regulations based on their own refusal to follow standard APA requirements for rulemaking. OAL should disapprove the proposed regulations in order to discourage future examples of this type of abuse of the emergency rulemaking process.

In sum, the Commissioner’s proposed amendments to the Rate Regulations are not aimed at addressing any purported “emergency” surrounding the July 14, 2008 ARF filing deadline, of which the CDI has been aware for over two years, and fail to meet the requisite necessity and clarity standards. Accordingly, OAL should reject the proposed “emergency” regulations.

Sincerely,

A handwritten signature in black ink, appearing to read 'Pamela Pressley', written in a cursive style.

Pamela Pressley
Litigation Director

cc: The Honorable Steve Poizner
Insurance Commissioner
State of California
California Department of Insurance
c/o Lara Sweat
Rate Enforcement Bureau
45 Fremont Street, 21st Floor
San Francisco, California 94105

Adam Cole, CDI General Counsel

EXHIBIT A

DEPARTMENT OF INSURANCE

Legal Division, Rate Enforcement Bureau
45 Fremont Street, 21st Floor
San Francisco, CA 94105



**NOTICE OF INFORMAL WORKSHOP
REGARDING VARIANCES SET FORTH IN
TITLE 10, CALIFORNIA CODE OF REGULATIONS, SECTION 2644.27**

PRIOR APPROVAL OF INSURANCE RATES

REG-2007-00023

April 2, 2007

The California Department of Insurance ("Department") hereby invites all interested persons to attend an informal workshop to discuss the prior approval formula and the procedural and substantive requirements applicable to the eleven variances set forth in Title 10, California Code of Regulations, Section 2644.7, filed with the Secretary of State on January 3, 2007, and operative April 3, 2007. The Department specifically intends to address the evidence required for and effect of each variance.

The informal workshop will be held as follows:

Wednesday, April 25, 2007 – 10:00 a.m.
California Department of Insurance
45 Fremont Street, 22nd Floor Hearing Room
San Francisco, CA 94105

The Department invites submission of written questions and/or comments regarding the variances in advance of the informal workshop. The Department will attempt to address the issues raised by submissions received on or before **April 16, 2007**. Although questions and comments may be submitted after that date, and may be submitted at the informal workshop, the Department may be unable to address questions and concerns submitted after April 16.

Written submissions, preferably by e-mail, should be directed to the Department's contact person for this informal workshop, set forth below. Additionally, please send a copy of all written submissions to those on the e-mail list for this informal workshop.

Any questions regarding this Notice should be directed to the contact person for this informal workshop:

Elizabeth Mohr
California Department of Insurance
Rate Enforcement Bureau
45 Fremont Street, 21st Floor
San Francisco, CA 94105
Telephone: (415) 538-4112
Facsimile: (415) 904-5490
mohre@insurance.ca.gov

EXHIBIT B

DEPARTMENT OF INSURANCE

RATE REGULATION BRANCH
300 SOUTH SPRING STREET
LOS ANGELES, CA 90013
(213) 346-6446
(213) 897-9051 (FAX)
www.insurance.ca.gov



October 29, 2007

Subject: Variance Process

Dear Interested Persons:

The CDI is currently reviewing the eleven variances associated with the Prior Approval Regulations (California Code of Regulations, Title 10, Section 2644.27(f)). I am concerned that the variances as currently written may need some amendment to operate as intended, to provide appropriate standards for granting or denying specific variances, and to provide sufficient instruction regarding what information or data to submit when an insurer is applying for a specific variance. A vital part of this review process is considering the views of both consumer groups and the insurance industry. Accordingly, I would greatly appreciate your views, comments, concerns and/or suggestions with regard to any of the variances. Please provide any comments by November 16, 2007.

After we have had a chance to review comments submitted, we anticipate having an informal workshop to discuss possible amendments to the regulation we are considering. We will advise at a later date as to the date and time for the workshop.

I look forward to your input.

Very Truly Yours,

A handwritten signature in black ink, appearing to read "SG", is written over a horizontal line.

Sherwood P. Girion
Deputy Commissioner
Rate Regulation Branch

EXHIBIT C

DEPARTMENT OF INSURANCE**Legal Division, Rate Enforcement Bureau**

45 Fremont Street

21st Floor

San Francisco, CA 94105



**NOTICE OF INFORMAL WORKSHOP
REGARDING POTENTIAL CHANGES TO PRIOR APPROVAL
REGULATIONS SET FORTH IN
TITLE 10, CALIFORNIA CODE OF REGULATIONS,
SUBCHAPTER 4.8 SECTIONS 2642.6 – 2644.27**

REG-2007-00046

March 19, 2008

The California Department of Insurance ("Department") invites all interested persons to attend an informal workshop to discuss the variances contained in the prior approval regulations set forth in Title 10, California Code of Regulations, Section 2644.27, filed with the Secretary of State on 1-3-2007, and operative on 4-3-2007 as well as other changes to Title 10, Subchapter 4.8 sections 2642.6 through 2644.27. The Department is considering the following amendments to the regulations:

- For section 2642.6: reducing the maximum recorded period to six years.
- For section 2642.7: adding surety to the lines of insurance and adding surety, credit and aviation as specialty lines.
- For section 2644.2: changing the maximum permitted earned premium and fixed investment income to factors and using a slightly different formula for credibility adjustment when reinsurance is allowed.
- For section 2644.3: changing the minimum permitted earned premium and fixed investment income to factors and using a slightly different formula for credibility adjustment when reinsurance is allowed.
- For section 2644.6: adding language to clarify the section.
- For section 2644.7: adding the requirement that insurers file using 12, 24 and 40 quarters of rolling calendar year data and identifying that the premium and loss trend factors will be developed using 12 quarters unless 24 or 40 quarters will provide a more actuarially sound result as selected by the Commissioner; clarifying that the "actuarially most sound" standard for credibility applies to lines other than homeowners and private passenger auto and allowing for use of at least 24 quarters if that produces the actuarially most sound result as decided by the Commissioner.
- For section 2644.8: changing reference to specialty lines to allow professional liability insurers to use their own actuarial judgment on trend, CAT factors and loss development and to allow specialty lines to use their own actuarial judgment on the entire ratemaking formula.
- For section 2644.12: making the standard for farmowners the average for all distribution systems combined, for earthquake defining the standard as excluding adjusting and other expenses and for burglary and theft allowing all distribution systems to be combined and a five year average to be used.
- For section 2644.17: allocating surplus on the sum of reserve plus premium.

- For section 2644.19: changing Fixed Investment Income to a factor.
- For section 2644.20: specifying which Mergent number to use for preferred stock yield.
- For section 2644.21: making the loss reserve ratio for burglary and theft the dollar-weighted average of the loss reserve ratios for fire, allied lines and inland marine.
- For section 2644.23: changing "+fixed invest inc" to "/(1-fixed invest inc factor)" and provide a slightly different formula for complementary losses when reinsurance is allowed.
- For section 2644.25: clarify that the term "reasonable" in subsections (i) and (j) has the same meaning as the term in subsection (d).
- For section 2646.4: allow for updates when interest rates (affecting rate of return and yield) change significantly.

For section 2644.27 the Department is considering the following changes:

- Deleting the variance for altering mix of business.
- Modifying the variance for loss prevention and loss reduction by specifically identifying that relief will be granted from the efficiency standard for additional expenses for loss prevention and loss reduction.
- Creating specific standards that must be met in order to obtain a variance based on loss prevention and loss reduction.
- Deleting the requirement that an insurer demonstrate savings commensurate with loss reductions.
- Adding objective criteria for what loss prevention expenses are recoverable.
- Deleting the variance for lower quality of service and inferior service to underserved communities and provide an objective definition for superior quality of service.
- Deleting the COIN variance (higher or lower financial investment in underserved communities.)
- Changing the variance based on 90% of business in one line or in California to apply to the leverage factor rather than rate of return and specifically identifying the adjustment to be .85 and limit the adjustment to either 90% of business in California or 90% premium in one line.
- Modifying the reasons why the loss trend may not produce an actuarially sound result to include not enough years of data and changing the 10 year period to at least 24 quarters.
- Providing that if there is more than one actuarial analysis of a variance, then the one that creates the most actuarially sound result must be used.
- Limiting the overall effect of combined variances to not exceed the efficiency standard.

A copy of the changes to be considered is attached.

The informal workshop will be held as follows:

Monday April 7, 2008 – 10:00 a.m.
 California Department of Insurance
 Hearing Room

45 Fremont Street, 22nd Floor
San Francisco, California 94105

The purpose of the workshop is to gather information with respect to the amending the regulations as described above. Therefore, the Department invites all interested parties to ~~present oral or written comments pertaining to the amendments under consideration at the~~ workshop. Participants should be prepared to present specific comments on, and/or alternate regulation language for, the regulations. Please be advised that participation in the workshop will be in addition to, and not in substitution for, any participation in a formal rulemaking process. This invitation does not constitute a Notice of Proposed Action under the Administrative Procedures Act.

If you are unable to attend the workshop, comments will be accepted until 5:00 p.m. on April 7, 2008. Please address all comments to the contact person below.

The facilities to be used for the public hearing are accessible to persons with mobility impairments. Persons with sight or hearing impairments are requested to notify the contact person for this workshop in order to make special arrangements, if necessary. In addition, any questions regarding this Notice should be directed to the contact person for this informal workshop:

Lara Sweat
Senior Staff Counsel
California Department of Insurance
Rate Enforcement Bureau
45 Fremont Street, 21st Floor
San Francisco, California 94105
Telephone: (415) 538-4192
Facsimile: (415) 904-5490-1883
sweatl@insurance.ca.gov

DEPARTMENT OF INSURANCE

Legal Division, Rate Enforcement Bureau
45 Fremont Street
21st Floor
San Francisco, CA 94105



**PROPOSED CHANGES TO THE PRIOR APPROVAL
REGULATIONS SET FORTH IN
TITLE 10, CALIFORNIA CODE OF REGULATIONS,
SUBCHAPTER 4.8 SECTIONS 2642.6 – 2644.27**

REG-2007-00046

March 19, 2008

§2642.6. Recorded Period.

"Recorded period" means the historical period from which data are taken to provide the basis for the proposed rate. The recorded period shall be the most recent three years for which reliable data are available, unless

(1) the credibility of that experience is less than the value contained in section 2644.23(gi). In that case, additional years shall be added to the recorded period until sufficient years are used to reach the credibility standard set forth in section 2644.23(gi). In no case shall the recorded period exceed ~~ten~~ six years.

(2) the data is fully credible with fewer than three years experience. In that case, only as many years as needed to be fully credible shall be used.

§2642.7. Lines of Insurance.

(a) Wherever in this subchapter insurance is required to be classified by line, the classification shall be into one of the following categories:

- (1) Fire
- (2) Allied Lines
- (3) Farmowners multiple peril
- (4) Homeowners multiple peril
- (5) Commercial multiple peril liability
- (6) Commercial multiple peril non-liability
- (7) Inland marine
- (8) Medical malpractice
- (9) Earthquake
- (10) Other liability
- (11) Products liability
- (12) Private passenger automobile liability
- (13) Private passenger automobile physical damage
- (14) Commercial automobile liability
- (15) Commercial automobile physical damage
- (16) Aircraft
- (17) Fidelity
- (18) Surety
- (189) Burglary and theft

(1920) Boiler and machinery.

(b) For purposes of this subchapter, mechanical breakdown and similar insurance covering loss caused by the failure or malfunction of a component or system of a motor vehicle, as described in California Insurance Code Section 116(c), shall be classified as other liability occurrence.

~~(c) Any insurer or the Commissioner may disaggregate any of the foregoing lines, except~~ homeowners multiple peril, private passenger automobile liability, and private passenger automobile physical damage, into two subcategories, "commodity" and "specialty." Rates for specialty insurance shall be approved or disapproved using the most sound actuarial method, consistent with California law, in accordance with the Actuarial Standards of Practice, and relevant and accepted actuarial principles, guidelines, and literature.

(d) Specialty insurance shall include:

(1) Any single policy having an annual premium over \$75,000;

(2) Any policy having a deductible or self-insured retention of \$100,000 or more;

(3) Any excess property, excess liability, or umbrella policy, where none of the underlying policies include private passenger automobile liability, private passenger automobile physical damage, or homeowners coverage, or where the underlying policy is written by an unaffiliated insurer and covers at least the first \$500,000 in losses;

(4) All policies for

(A) nuclear risks,

(B) pollution legal liability,

(C) product-tampering, product impairment, or product recall,

(D) kidnap and ransom,

(E) political risks,

(F) directors' and officers' liability,

(G) boiler and machinery insurance,

(H) fidelity insurance,

(I) mortgage guaranty insurance,

(J) employer liability under the United States Longshoremen's and Harbor Workers' Compensation Act (33 U.S.C. section 901 et seq.), the Jones Act (46 U.S.C. section 688), the Federal Employer Liability Act (45 U.S.C. section 51 et. seq.), or any similar statute,

(K) excess employer's liability over workers' compensation insurance; and,

(L) Differences in conditions coverage.,

(M) surety,

(N) credit, and

(O) aviation.

(e) Commodity insurance shall include all policies in the line that are not defined in this section as specialty.

§2644.2. Maximum Permitted Earned Premium.

The maximum permitted earned premium is calculated as follows:

(a) the quotient of

(1) the sum of

(A) (i) projected losses, as defined in section 2644.4,

(2) (ii) plus projected defense and cost containment expenses, as defined in section 2644.8,

(B) multiplied by 1 minus the fixed investment income factor as defined in section 2644.19(a)

(32) minus projected ancillary income, as defined in section 2644.13,

(4) minus fixed investment income, as defined in section 2644.19(a);

(b) divided by the maximum denominator, as defined in section 2644.2(c).

Stated as a formula:

$$\text{Max Permitted EP} = \frac{\text{losses} + \text{DCCE} - \text{ancil income} - \text{fixed invest inc}}{\text{max denom}}$$

$$\text{Max Permitted EP} = \frac{(\text{losses} + \text{DCCE}) \times (1 - \text{fixed invest inc factor}) - \text{ancil income}}{\text{max denom}}$$

(c) The maximum denominator means:

(1) 1.0,

(2) minus the efficiency standard, as defined in section 2644.12,

(3) minus the maximum profit factor, as defined in section 2644.15,

(4) plus the variable investment income factor, as defined in section 2644.19(b).

Stated as a formula:

$$\text{Max denom} = 1 - \text{eff std} - \text{profit factor} + \text{var invest inc factor}$$

§ 2644.3. Minimum Permitted Earned Premium.

The minimum permitted earned premium is calculated as follows:

(a) the quotient of

(1) the sum of

(A)(i) projected losses, as defined in section 2644.4,

(2) (ii) plus projected defense and cost containment expenses, as defined in section 2644.8,

(B) multiplied by 1 minus the fixed investment income factor as defined in section 2644.19(a)

(32) minus projected ancillary income, as defined in section 2644.13,

(4) minus fixed investment income, as defined in section 2644.19(a);

(b) divided by the minimum denominator, as defined in section 2644.3(c).

Stated as a formula:

$$\text{Min Permitted EP} = \frac{\text{losses} + \text{DCCE} - \text{ancil income} - \text{fixed invest inc}}{\text{min denom}}$$

$$\text{Min Permitted EP} = \frac{(\text{losses} + \text{DCCE}) \times (1 - \text{fixed invest factor}) - \text{ancil income}}{\text{min denom}}$$

(c) The minimum denominator means:

(1) 1.0,

(2) minus the efficiency standard, as defined in section 2644.12,

- (3) minus the minimum profit factor, as defined in section 2644.15,
(4) plus the variable investment income factor, as defined in section 2644.19(b).

Stated as a formula:

Min denom = 1 - eff std. - profit factor + var invest inc factor

§2644.6. Loss Development.

"Loss development" is the process by which reported losses are adjusted for anticipated payout patterns. Loss development shall be presented as a loss-development triangle, based on the dollar-weighted average of the ratios of losses for the three most recent accident-years, policy-years or report-years available for a reporting interval. Filings shall contain both paid losses and case-specific reserves, stated separately. Loss development shall employ either paid losses or the sum of paid losses and case-specific reserves. The insurer shall submit both the factors and ultimate losses or claims for both the paid and incurred loss development and the reported claims and the paid claims development calculations, and shall demonstrate that its selection is the most actuarially reasonable sound. Loss development data shall exclude catastrophes. Where the loss development factors within a given line significantly vary by subline, by size of loss, or by coverage, separate loss development factors shall be calculated in accordance with that evidence.

§2644.7. Loss and Premium Trend.

"Loss trend" and "premium trend" is the process by which forces not reflected in historical loss and premium data are expected to affect losses and premiums in the rating period.

(a) Trend factors shall be based on the exponential curve of best fit. Companies shall file the most recent 12, 24 and 40 quarters of rolling calendar year data excluding catastrophes. The Ppremium and loss trend factors shall be developed using the insurer's company-specific most recent twelve quarters of rolling calendar year data excluding catastrophes. The Commissioner may select the most recent 24 or 40 quarters of data if either of those periods provide a more actuarially sound result. Frequency trend shall be calculated as reported or closed claims divided by exposures. Severity trend shall be calculated on paid losses divided by closed claims or total paid losses, including partial payments in previous calendar years, on closed claims divided by closed claims. The insurer shall submit the frequency and severity calculations on ~~both~~ all bases, and shall demonstrate that its selection is the most actuarially-reasonable sound. Premium trend factors shall be developed using company-specific premium per exposure data.

(b) Where the trend factor within a given line significantly varies by subline, by policy limits, by region of the state, or by coverage, separate trend factors shall be calculated in accordance with that evidence.

(c) For homeowners multiple peril and private passenger automobile liability and physical damage, the standard for full credibility for loss trend shall be 6000 total claims over the same number of quarters as used in subsection (a) 12 quarter period for each form for homeowners and for each coverage for private passenger automobile. Partial credibility shall be the square root of the ratio of the actual number of claims divided by the full credibility standard. For private passenger automobile other than motorcycle, the complement of credibility for loss trend shall be calculated using the latest available California Fast Track paid loss, closed claim count and earned exposure data. The complement shall be based on the exponential curve of best fit to the most recent twelve quarters of rolling calendar year data. For uninsured and

underinsured motorist bodily injury and medical payments coverages, the complement shall use the California Fast Track bodily injury data. For uninsured and underinsured motorist property damage coverages, the complement shall use the California Fast Track property damage data. The Commissioner may modify the result of the calculation from California Fast Track data to take into account factors not reflected in the historical data, pursuant to section 2646.3.

~~(d) For lines of business other than homeowners multiple peril and private passenger automobile liability and physical damage, the standard for full credibility and the complement of credibility for loss trend shall be determined using the most actuarially sound method.~~

§2644.8. Projected Defense and Cost Containment Expenses.

(a) "Projected defense and cost containment expenses" means the company's historic costs per exposure associated with the defense and cost containment of claims, adjusted for catastrophes, developed and trended in the manner described in sections 2644.5, 2644.6 and 2644.7.

(b) 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 insurer shall demonstrate that its selection is the most actuarially reasonable sound.

~~(c) Where an insurer or the Commissioner elects to disaggregate a line of insurance into commodity and specialty categories pursuant to section 2642.7, the insurer may, in addition to the computation of projected defense and cost containment expenses specified in this section, tender an alternative computation of projected defense and cost containment expenses for the specialty category, which the Commissioner shall approve if he or she finds the projection to have been made in a sound actuarial manner.~~ For professional liability and errors and omissions coverage, the insurer shall tender an alternative computation of projected defense and cost containment expenses, which the Commissioner shall approve if he or she finds the projection to have been made in the most sound actuarial manner. Nothing in this section precludes the Commissioner from requiring the additional filing of projected defense and cost containment expenses computed in the manner specified in sections (a) and (b).

§2644.11. Expense Trend

§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 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 efficiency standard shall be calculated as the arithmetic average of the latest three years for which data are available.

(d) For farmowners, the efficiency standard for captive insurers shall be the average for all distribution systems combined.

(e) For earthquake, the 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.

(dg) In each category, the efficiency standard shall be set at 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.

(eh) 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.

(fi) 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%.

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

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

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

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

(kn) 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.

§2644.17. Leverage Factor and Surplus.

(a) "Leverage factor" means the ratio of earned premiums to the average of year-beginning and year-end surplus.

(b) 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 factors shall be calculated using the consolidated underwriting and investment exhibit as published in Best's Aggregates and Averages. The allocation of the commercial multiple peril data to liability and non-liability and the allocation of the automobile physical damage data to private passenger and commercial shall be done using data from the Exhibit of Premiums and losses (Statutory Page 14 Data) as published in Best's Aggregates and Averages. For medical malpractice, other liability and product liability, there shall be separate leverage factors for claims-made and occurrence. Total national industry surplus shall be allocated to lines of business in proportion to the sum of the national industry-wide earned premium, unearned premium, loss and loss adjustment expense reserves. The leverage factor for each line of business shall be the national premium divided by the allocated surplus.

Notwithstanding the result of the calculation, the leverage factor for earthquake shall be 1.0. For other lines of business subject to catastrophes, mass torts and other unusual events, the Commissioner shall modify the leverage factors where he finds that they do not provide a reliable estimate of future risk, pursuant to section 2646.3.

(c) The Commissioner finds that investors' perceived investment risk may vary from line to line. Thus, while the rate of return does not vary by line, insurance perceived to have a greater risk will yield higher returns per premium dollar:

§2644.19. Investment Income Factors.

(a) "Fixed investment income factor" means the projected yield, as defined in section 2644.20,

(1) multiplied by the ratio of the investment federal income tax factor and the underwriting federal income tax factor, as defined in section 2644.18,

(2) multiplied by the loss reserves ratio, as defined in section 2644.21,

~~(3) multiplied by the sum of~~

~~(A) the projected losses, as defined in section 2644.4,~~

~~(B) plus the projected defense and cost containment expenses, as defined in section 2644.8.~~

Stated as a formula:

$$\text{Fixed invest inc} = \text{yield} \times \frac{\text{FIT}_{inv inc} \times \text{loss reserves ratio} \times (\text{loss} + \text{DCCE})}{\text{FIT}_{und}}$$

$$\text{Fixed invest inc factor} = \frac{\text{yield} \times \text{FIT}_{inv inc} \times \text{loss reserves ratio}}{\text{FIT}_{und}}$$

(b) "Variable investment income factor" means the projected yield, as defined in section 2644.20,

(1) multiplied by the ratio of the investment federal income tax factor and the underwriting federal income tax factor, as defined in section 2644.18,

(2) multiplied by the sum of

(A) the unearned premium reserves ratio, as defined in section 2644.21,

(B) plus the surplus ratio, as defined in section 2644.22

Stated as a formula:

$$\text{Var invest inc factor} = \text{yield} \times \frac{\text{FIT}_{\text{inv inc}}}{\text{FIT}_{\text{und}}} \times (\text{uep reserves ratio} \mp \pm \text{surplus ratio})$$

§2644.20. Projected Yield.

(a) "Projected yield" means the weighted average yield computed using the insurer's actual portfolio and yields currently available on securities in US capital markets. The weights shall be determined using the insurer's most recent consolidated statutory annual statement, and shall be computed by dividing the insurer's assets in each separate asset class shown on page 2, lines 1 through 9 of the insurer's consolidated statutory annual statement, by the total of lines 1 through 9. The yields for each asset class shall be based on an average of the most recent available 3 complete months, as of the date of filing.

(b) The bond asset class shall be subdivided into the issuer categories of US government bonds, other taxable bonds and tax exempt bonds and into the maturity categories of short, intermediate and long-term shown. For the purposes of this section, "US government" means the sum of rows 1.7, U.S. governments, and 2.7, all other governments, of schedule D, part 1A, section 1 of the insurer's consolidated statutory annual statement, "other taxable" means the sum of rows 6.7, public utilities, 7.7, industrial and miscellaneous, 8.7, credit tenant loans, 9.7, parent subsidiaries and affiliates and half of row 5.7, special revenue and special assessments and "tax-exempt" means the sum of rows 3.7, states, territories and possessions, 4.7, political subdivision of states, territories and possessions, and half of row 5.7. For the purposes of this section, "short-term" means one year or less, "intermediate-term" means more than one year through 10 years, and "long-term" means more than 10 years.

(c) "Yields currently available on securities in US capital markets" means,

(1) US government bonds

(A) Short: yield on the nominal 3-month constant maturity US Treasury bill as provided in the Federal Reserve H.15 statistical release

(B) Intermediate: yield on the nominal 10-year constant maturity US Treasury bond as provided in the Federal Reserve H.15 statistical release

(C) Long: yield on the nominal 20-year constant maturity US Treasury bond as provided in the Federal Reserve H.15 statistical release

(2) Other taxable bonds

(A) Short: yield on 3-month financial commercial paper as provided in the Federal Reserve H.15 statistical release

(B) Intermediate: average yield on 10-year corporate A and AA rated bonds as provided by Valu/Bond on Yahoo.com

(C) Long: average yield on 20-year corporate A and AA rated bonds as provided by Valu/Bond on Yahoo.com

(3) Tax exempt bonds

(A) Short: yield on short-term other taxable bonds times 1 minus the federal income tax rate of 35%

(B) Intermediate: average yield on 10-year municipal A and AA rated bonds as provided by Valu/Bond on Yahoo.com

(C) Long: average yield on 20-year municipal A and AA rated bonds as provided by Valu/Bond on Yahoo.com

(4) Common stock
(A) Dividends: ten-year average income return as provided in the Ibbotson yearbook
(B) Capital gains: the risk-free rate, below, plus 8%, which the Commissioner finds represents the risk-premium for common stock investments generally, minus dividends, above
(5) Preferred stock dividends: average yield on Moody's A-rated public utility preferred stocks as provided by Mergent Bond Record

(6) Mortgage loans: yield on long-term other taxable bonds, above
(7) Real estate: the risk-free rate, below, plus 2%, which the Commissioner finds represents the risk-premium for real estate investments
(8) Cash and short term: yield on short-term US Treasury bills, above
(9) Other: yield on common stock, above
(d) The "risk-free rate" means the average of the short, intermediate and long-term US government bonds, above, except that the short-term shall be one month instead of three and the intermediate term shall be five years instead of ten.

(e) The projected yield shall be reduced by the ratio of incurred investment expenses, page 11, line 25, column 3, of the insurer's consolidated statutory annual statement, divided by the total of cash and invested assets, page 2, line 10.

(f) The projected yield shall be multiplied by the ratio of cash and invested assets, page 2, line 10 of the insurer's consolidated statutory annual statement, divided by the sum of reserves, page 3, lines 1, 3 and 9, and surplus, page 3, line 35.

§2644.21. Reserves Ratio.

(a) "Unearned premium reserves ratio" means
(1) the average of the last two years ending unearned premium reserves
(2) divided by the earned premium for the most recent year for which data are available.
(b) "Loss reserves ratio" means
(1) the average of the last two years ending
(A) loss reserves plus
(B) loss adjustment expense reserves
(2) divided by the incurred loss and defense and cost containment expense for the most recent year for which data are available.

(c) For burglary and theft, the loss reserve ratio shall be the dollar-weighted average of the loss reserve ratios for fire, allied lines and inland marine.

There shall be one industry-wide unearned premium reserves ratio and one loss reserves ratio for each line of business. The industry-wide numbers shall be the sum of all such numbers taken from the California state page of the statutory annual statement for all insurers doing business in California. Countrywide adjusting and other expense reserves from Best's Aggregates & Averages shall be allocated to California by loss and defense and cost containment reserves. For medical malpractice, other liability and products liability, California premium and reserves shall be allocated between occurrence and claims-made using countrywide numbers from Best's Aggregates & Averages. The Commissioner shall perform the calculation within 45 days of the publication of the necessary source data. Notwithstanding the result of the calculation, the loss reserves ratio for earthquake shall be 1.0. 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.

§2644.23. Credibility Adjustment.

(a) To the extent that the maximum and minimum permitted earned premiums are based upon data that lack credibility, a credibility adjustment shall be made.

(b) For each form for homeowners multiple peril and for each coverage for private passenger auto liability and physical damage the standard for full credibility shall be 3000 claims. Partial credibility shall be the square root of the ratio of the actual number of incurred claims in the experience period divided by the full credibility standard. For lines of business other than homeowners multiple peril and private passenger automobile liability and physical damage, the standard for full and partial credibility shall be determined using the most actuarially sound method.

(c) When the loss and defense and cost containment expense data is less than fully credible, in the maximum and minimum premium formulas in sections 2644.2 and 2644.3, the following shall be substituted:

- (1) The sum of
 - (A) the credibility weight, as defined in section 2644.23(b),
 - (B) multiplied by the sum of
 - (i) projected loss, as defined in section 2644.4,
 - (ii) plus projected defense and cost containment expense, as defined in section 2644.8,
- (2) plus
 - (A) the difference of
 - (i) 1.0
 - (ii) minus the credibility weight, as defined in section 2644.23(b),
 - (B) multiplied by the complementary loss and defense cost containment expense, as defined in section 2644.23(d).

Stated as a formula:

$$\text{Credibility weight} \times (\text{loss} + \text{DCCE}) + (1 - \text{credibility weight}) \times \text{comp loss DCCE}$$

- (d) The complementary loss and defense and cost containment expense means
- (1) the quotient product of
 - (A) the sum of
 - (i) the trended current rate level premium, as defined in section 2644.24,
 - (ii) multiplied by 1.0 plus the complement trend, as defined in section 2644.23(eg),
 - (iii) multiplied by the maximum denominator, as defined in section 2644.2(c).
 - (2B) plus the sum of
 - (i) the ancillary income, as defined in section 2644.13, and
 - (ii) divided by 1 minus the fixed investment income factor, as defined in section 2644.19.

Stated as a formula:

$$\text{Comp loss DCCE} = (\text{TCRLP} \times (1 + \text{comp trend}) \times \text{max denom} + \text{ancil income} + (1 - \text{fixed invest inc factor}))$$

(e) Where the cost of reinsurance is allowed, as provided in section 2644.25, the credibility adjustment in subsection (c) shall be made to loss plus defense and cost containment expense minus reinsurance recoverables, as defined in section 2644.26.

(f) Where the cost of reinsurance is allowed, as provided in section 2644.25, the complementary loss and defense and cost containment expense means

(1) the quotient of

(A) the sum of

(i) the trended current rate level premium, as defined in section 2644.24,

(ii) multiplied by 1.0 plus the complement trend, as defined in section 2644.23(g),

(iii) multiplied by the maximum denominator, as defined in section 2644.2(c).

(B) plus the ancillary income, as defined in section 2644.13,

(C) minus the product of

(i) the reinsurance premium, as used in section 2644.25, divided by 1 minus the variable expense factor, as defined in section 2644.14,

(ii) multiplied by the maximum denominator, as defined in section 2644.2(c),

(2) divided by 1 minus the fixed investment income factor, as defined in section 2644.19.

Stated as a formula:

$$\text{Comp loss DCCE} = (\text{TCRLP} \times (1 + \text{comp trend}) \times \text{max denom} + \text{ancil income} - \text{reins prem} / (1 - \text{var exp factor}) \times \text{max denom}) / (1 - \text{fixed invest inc factor})$$

(eg) The complement trend means the annual net trend plus one, raised to the power of the number of years from the effective date of the current rate to the proposed effective date of the proposed rates, minus one.

Stated as a formula:

$$\text{Comp trend} = ((\text{annual net trend} + 1)^{\text{number of years}}) - 1$$

If the number of years from the effective date of the current rate to the proposed effective date of the proposed rates exceeds four, the complement trend shall be the annual net trend plus one, raised to the fourth power, minus one.

(fh) The annual net trend is the ratio of the loss trend, as defined in section 2644.7, annualized, plus one, divided by the premium trend, as defined in section 2644.7, annualized, plus one, minus one.

Stated as a formula:

$$\text{Annual net trend} = ((\text{annual loss trend} + 1) / (\text{annual premium trend} + 1)) - 1$$

(gi) If the credibility weight is less than 25% the applicant or the Commissioner may use an alternative complementary loss and defense and cost containment expense, provided that the alternative is the most actuarially sound method and reasonable in the circumstance.

§2644.25. Reinsurance.

(a) For all lines and sublines except for those listed in the next subparagraph, ratemaking shall be on a direct basis, with no consideration for the cost or benefits of reinsurance.

(b) For earthquake and for medical malpractice facultative reinsurance with attachment points above one million dollars, the maximum permitted earned premium is calculated as follows:

- (1) The sum of
 - ~~(A)(1)~~ the quotient of
 - ~~(A) the difference of~~
 - (i) the product of
 - (a) the projected losses, as defined in section 2644.4, (ii) plus the projected defense and cost containment expense, as defined in section 2644.8, (iii) minus the projected reinsurance recoverables, as defined in section 2644.26,
 - (b) multiplied by 1 minus the fixed investment income factor, as defined in section 2644.19(a),
 - (iv) ii) minus the projected ancillary income, as defined in section 2644.13,
 - ~~(v) minus the fixed investment income, as defined in section 2644.19(a),~~
 - ~~(B)(B)~~ divided by the sum of
 - (i) 1.0,
 - (ii) minus the efficiency standard, as defined in section 2644.12,
 - (iii) minus the maximum profit factor, as defined in section 2644.15,
 - (iv) plus the variable investment income factor, as defined in section 2644.19(b).
 - (2) plus the quotient of
 - (A) the reinsurance premium, net of ceding and contingent commissions,
 - (B) divided by the difference of
 - (i) 1.0,
 - (ii) minus the variable expense factor, as defined in section 2644.14.

Stated as a formula:

$$\frac{\text{Max permitted EP} = \frac{\text{losses} + \text{DCCE} - \text{recoverables} - \text{ancil inc} - \text{fixed invest inc} + \text{reins premium}}{1 - \text{eff std} - \text{profit factor} + \text{var invest inc factor}}}{1 - \text{var exp factor}}$$

$$\text{Max permitted EP} = \frac{(\text{losses} + \text{DCCE} - \text{recoverables}) \times (1 - \text{fixed invest income factor}) - \text{ancil inc.} + \text{reins premium}}{1 - \text{eff std} - \text{profit factor} + \text{var invest inc factor} \quad 1 - \text{var exp factor}}$$

(c) For the calculation of fixed investment income factor, the numerator and denominator of the loss reserves ratio shall be adjusted for projected reinsurance recoverables, and for the variable investment income factor, the numerator and denominator of the unearned premium reserve ratio shall be adjusted to reflect the cash flows of the unearned reinsurance premium.

(d) Reinsurance costs shall only be allowed for ratemaking purposes as set forth in this section 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.

(e) There will be no allowance for reinsurance between affiliated entities as set forth in Schedule Y of the Annual Statement.

(f) There will be no allowance for reinsurance through unauthorized reinsurers.

(g) Copies of the reinsurance agreements shall be submitted with the filing.

(h) For the purposes of this section and section 2644.26, reinsurance shall include other risk financing mechanisms, such as catastrophe bonds.

(i) For the earthquake line, if at least 30% of the requested rate results from the cost of reinsurance, and a consumer or his or her representative requests a hearing within 45 days of public notice, the Commissioner shall hold a hearing on the issue of the reasonableness of the reinsurance costs, ~~as defined in section (d), and whether some or all of those costs shall be~~ reflected in the proposed rate change. An insurer's rate application shall indicate whether at least 30% of the requested rate results from the cost of reinsurance.

(j) For the medical malpractice line, if at least 30% of the requested rate is attributable to the cost of facultative reinsurance with attachment points above one million dollars, and a consumer or his or her representative requests a hearing within 45 days of public notice, the Commissioner shall hold a hearing on the issue of the reasonableness of the reinsurance costs, as defined in section (d), and whether some or all of those costs shall be reflected in the proposed rate change. An insurer's rate application shall indicate whether at least 30% of the requested rate results from the cost of reinsurance.

§2646.4. Hearings on Individual Insurers' Rates.

(a) This section applies to any request for a hearing on an individual insurer's rates, and applies to both requests made prior to a rate becoming effective and to requests concerning a rate in effect.

(1) A request for a hearing on a rate application shall be either delivered or mailed to the Department of Insurance within 45 days of the public notice specified in subdivision (c) of Insurance Code section 1861.05.

(2) A request for a hearing at any other time shall be based on the allegation that, pursuant to subdivision (a) of Insurance Code section 1861.05, a rate is "in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of" chapter 9 (commencing with section 1851) of part 2 of division 1 of the Insurance Code.

(b) A hearing on a rate application, and a hearing based on the allegation that a rate in effect is excessive, inadequate, unfairly discriminatory or otherwise in violation of chapter 9 (commencing with section 1851) of part 2 of division 1 of the Insurance Code shall be for the purpose of determining whether

(1) the insurer has properly applied the statute and these regulations in calculating the maximum or minimum permitted earned premium; or

(2) the maximum permitted earned premium or minimum permitted earned premium calculated on the basis of the statute and these regulations, should be adjusted as provided in section 2644.27. A request that the maximum permitted earned premium or minimum permitted earned premium should be adjusted is referred to as a "variance request."

(c) Relitigation in a hearing on an individual insurer's rates of a matter already determined either by these regulations or by a generic determination is out of order and shall not be permitted. However, the administrative law judge shall admit evidence he or she finds relevant to the determination of whether the rate is excessive or inadequate (or, in the case of a proceeding under Article 5, relevant to the determination of the minimum nonconfiscatory rate), whether or not such evidence is expressly contemplated by these regulations, provided the evidence is not offered for the purpose of relitigating a matter already determined by these regulations or by a generic determination.

(d) If, at any time after a hearing has been noticed, the risk-free rate as defined in section 2644.20(d) has changed by two percent or more from the risk-free rate used in the filing, the maximum and minimum permitted premium earned shall be recalculated using an updated risk-free rate of return.

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 Form CA-RA9 pages 11a and 11 b 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 efficiency standard, rate of return, loss development factors or trend which will result if the variance is granted 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 in the applicable efficiency standard, rate of return, loss development factors or trend that is being proposed 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:

(1) 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

(2) 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 will alter its mix of business in the rating period from the mix in the recorded period in a manner that affects the maximum and minimum permitted earned premium. Any such representation by the insurer shall specify the precise changes in business operations; shall be supported by a statement of an authorized official of the insurer indicating the manner in which the insurer plans to implement the change, and shall include such substantiating information as the Commissioner may require, including but not limited to specification of changes in the insurer's marketing program and relevant market research. Such representation shall be accompanied by the stipulation by the insurer to refund to consumers in a subsequent rate case if the change fails to materialize.~~

(2) That the insurer should be allowed to recover additional costs relief from the efficiency standard for bona fide loss-prevention and loss-reduction activities, provided the

insurer can demonstrate loss reductions commensurate with the increased expenditures 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(e). The term Allocated Total 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 adjustors 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 Cost 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.

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

(A) higher or lower Superior quality of service, as demonstrated by external objective measures of consumer satisfaction; or such as the J.D. Power Ratings, or the California Department of Insurance Consumer Complaint Study. An insurer rated in the J.D. Power National Study will qualify for this variance only if it is rated as "among the best" or "better than most" in "overall experience."

(B) demonstrably superior or inferior service to underserved communities, as defined in section 2646.6; or as demonstrated by the number of policies sold in underserved communities.

(i) Underserved Communities means those communities which the Commissioner has determined are underserved as set forth in the "Commissioner's Report on Underserved Communities."

(ii) Superior is defined as those insurers whose percentage of total earned exposures in underserved communities are in the top 25% weighted by exposure of insurers.

(C) significantly smaller or larger than average California policy size 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.

(D) The relief allowed for a variance based on subsections (A) or (B) shall be limited to 2% for each.

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

(5) That the insurer should be authorized a rate of return leverage factor different from the rate of return leverage factor determined pursuant to section 2644.167 on the ground 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.

(64) 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.

~~(75) 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.~~

(86) 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.

(97) That the loss development formula in section 2644.6 does not produce an 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.

~~(108) That the trend formula in section 2644.7 does not produce an 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;~~

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

~~(CD) It can be shown that a trends other than 12 quarters calculated over at least a 10 year 24 quarter period are is more reliable prospectively;~~

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

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

(119) 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. 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.

EXHIBIT D

DEPARTMENT OF INSURANCE**Legal Division, Rate Enforcement Bureau**

45 Fremont Street, 21st Floor
San Francisco, CA 94105



**NOTICE OF PROPOSED EMERGENCY ACTION
AND FINDING OF EMERGENCY
PURSUANT TO CALIFORNIA INSURANCE CODE SECTION 12921.7**

REG-2007-00046

April 21, 2008

PRIOR APPROVAL REGULATIONS

California Insurance Commissioner Steve Poizner (the "Commissioner") hereby provides notice, pursuant to California Insurance Code section 12921.7 that he will propose to the Office of Administrative Law ("OAL") the adoption of emergency amendments to the Prior Approval Regulations, referenced in Title 10, Chapter 5, Subchapter 4.8, Article 2, Sections 2642.6, 2642.7, and Article 4 Sections 2644.2, 2644.3, 2644.6, 2644.7, 2644.8, 2644.11, 2644.12, 2644.17, 2644.19, 2644.20, 2644.21, 2644.23, 2644.25 and 2644.27 of the California Code of Regulations, on an emergency basis pursuant to California Government Code section 11346.1(b).

This Notice contains a description of the facts demonstrating the existence of an emergency and the necessity for the regulations, along with a copy of the text of the emergency regulations.

This Notice is provided to every person, group, and association who has previously filed a request for notice of regulatory action with the Commissioner. Copies of the Notice and studies are available at the Department of Insurance, 45 Fremont Street, 21st Floor, San Francisco, California, 94105 and on the Department's web site at www.insurance.ca.gov.

The proposed regulation will be submitted to the OAL together with the rulemaking file not less than five (5) working days after the mailing of this Notice, as required by California Insurance Code section 12921.7. Questions regarding this Notice should be directed to:

California Department of Insurance
Legal Division
Attn: Lara Sweat, Senior Staff Counsel
45 Fremont Street, 21st Floor
San Francisco, California 94105
(415) 538-4192

The Commissioner hereby finds that an emergency exists, and that the following amendments to the Prior Approval Regulations, referenced in Title 10, Chapter 5, Subchapter 4.8, Article 2, Sections 2642.6, 2642.7, 2642.8 and Article 4 Sections 2644.2, 2644.3, 2644.6, 2644.7, 2644.8, 2644.11, 2644.12, 2644.17, 2644.19, 2644.20, 2644.21, 2644.23, 2644.25 and 2644.27 of the

California Code of Regulations, are necessary for the immediate preservation of the public peace, health and safety, or general welfare.

INFORMATIVE DIGEST / POLICY STATEMENT OVERVIEW

Existing law, Proposition 103 (Insurance Code sections 1861.01 *et seq.*), an initiative approved by the California voters on November 8, 1988, establishes a system of prior approval rate regulation for property-casualty insurance lines (except those listed in Insurance Code section 1851). In 1991 the Department adopted regulations which provided a formula to determine whether a rate was excessive or inadequate. These regulations were upheld in *20th Century Insurance Company v. Garamendi* (1994) 8 Cal.4th 216 recognizing that the Department's use of a general formula could help reduce the task of reviewing rate applications to a "manageable size." Each section of these regulations is part of the comprehensive formula used to determine rates. All the sections work together to help determine an appropriate insurance rate, that is, one that is neither excessive nor inadequate.

DESCRIPTION OF PROBLEM AND NECESSITY FOR REGULATION

In 2006, the Department made comprehensive revisions to the prior approval regulations (RH05042749) which were effective in April 2007 (the "2007 revisions"). The 2007 revisions included significant changes to the prior approval regulations including existing variances and the creation of new variances. A variance will allow deviation from the prior approval regulations for certain specified reasons such as lack of data or solvency issues. Variances are crucial to the ratemaking process because they can recognize and allow for the uniqueness of an insurer's experience data by line and program.

The 2007 revisions were intended to simplify the prior approval process and to provide some flexibility in certain situations as warranted by the variances.

Since the 2007 revisions have been in effect, certain issues were identified both by the Department and insurers with regard to the administration of the variances. After these issues were identified, the Department invested considerable time and effort in the development of standards and benchmarks and other revisions to the prior approval regulations which were not able to be addressed in the 2007 revisions.

The goal of this rulemaking is to make necessary changes to the variances and other associated prior approval regulations.

JUSTIFICATION FOR ADOPTION AS EMERGENCY REGULATIONS

Regulations were created as a means to determine whether a rate is excessive or inadequate. The use of regulations for this process was upheld in *20th Century* where the court recognized that regulations providing for a general formula were an appropriate method for managing the number of rate applications. In order for the Department to be able to review the large number of rate application it receives each year, rules of general application must be in place, thus a regulation.

This rulemaking is necessary to resolve the issues with the variances as well as to address other issues that arose after the 2007 revisions.

Since the revisions went into effect in April 2007, the Department and insurers began to notice certain issues with the administration of the variances. As it became clear that administering the variances was problematic, the Department began to develop amendments to the regulations as well as to other sections of the prior approval regulations that were not able to be addressed during the 2007 revisions or that arose as a result of the 2007 revisions. However, due to the highly technical nature of the prior approval regulations and variances, there was no way to craft a “quick fix.” The proposed regulation changes are a result of several months of study, discussion and refinement as each part of the regulatory scheme is part of a comprehensive formula used to determine rates. The components all work together to complete the calculation for a maximum and minimum permitted earned premium and determine the appropriate rate. Every section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable.

The Department has moved quickly to resolve the issues with the 2007 revisions and regulations and therefore these revisions need to be put into place as soon as possible. The Department has identified a significant decrease in rate applications in 2007. Insurance is multi billion dollar industry, affecting almost every citizen of the state. It is necessary to have an appropriate, properly functioning mechanism for determination of rates.

These regulations need to be enacted on an emergency basis in order to have a fully functioning regulatory scheme. Pursuant to CCR section 2632.11(c)(1), private passenger automobile insurers must fully comply with the 2006 amendments to the automobile rating factor regulations (the “ARFs”) by July 14 of 2008. Insurers are also required to file rate applications with the class plan.

If these regulations are not enacted on an emergency basis, changes to rates, specifically prior passenger automobile rates, will occur in two parts, the first with the ARF filing and then further changes pursuant to these revisions as the ARF deadline is earlier than the regular rulemaking process deadline. In order to harmonize both regulatory schemes, these amendments must be implemented before the ARF deadline. Accordingly, the Commissioner must utilize the emergency regulations procedures; otherwise the coverage and rate changes to be implemented via the ARF filings will not occur in harmony with rate changes resulting from these revisions.

The only way to immediately protect the public’s interest in this case is if the regulations are adopted on an emergency basis. Requiring insurers to file two rate filings, one right after another, would cause tremendous confusion in the marketplace. As a result insurers will face difficulties implementing their rating plans and insureds may be displaced as insurers implement one rating plan in order to comply with the ARF deadline and then another rating plan to comply with revisions to the prior approval regulations.

California case law supports the Commissioner’s decision to promulgate emergency regulations in this instance. In *Schenley Affiliated Brands Corp. v. Kirby* (Cal. Ct. App. 1971) 21 Cal. App.3d 177 the court held that an agency did not abuse its discretion in promulgating emergency regulations where other regulations were about to go into effect and additional regulations were needed in order to achieve a fully operational regulatory scheme.

Lastly the amendments are necessary prior to the ARF filing deadline to allow the Department to handle the large number of filings anticipated. Currently only about twenty percent of private passenger automobile insurers have complied with the ARF deadline which means an influx of filings which the Department will have to review within the statutorily prescribed time frame of 60 days. Without these revisions in place, it will be difficult for the Department to properly review the large number of private passenger automobile filings within the designated time frame. The revised regulations provide clarity with better defined benchmarks and will make the development and submission of the ARF filings less cumbersome and time consuming for both insurers and the Department.

AUTHORITY UNDER WHICH REGULATIONS ARE PROPOSED

These regulations are specifically authorized by California Insurance Code sections 1861.01 and 1861.05. These regulations would implement, interpret or make specific Insurance Code sections 1861.01 and 1861.05.

Because this proposed rulemaking action concerns ratemaking, California Government Code section 11340.9(g) applies.

COMPARABLE FEDERAL LAW

There are no comparable existing federal regulations or statutes.

LOCAL MANDATE DETERMINATION

The Insurance Commissioner has initially determined that the proposal will not result in any new program mandates on local agencies or school districts.

COST OR SAVINGS TO STATE OR LOCAL AGENCIES / SCHOOL DISTRICTS / FEDERAL FUNDING

The Insurance Commissioner has initially determined that the proposal will not result in any cost or significant savings to any state agency or to any local agency or school district for which Part 7 (commencing with section 17500) of Division 4 of the Government Code would require reimbursement, or in other nondiscretionary costs or savings to local agencies. Nor will the proposal affect federal funding to the state.

TECHNICAL STUDIES OR REPORTS RELIED UPON

CDI study "Calculation of Leverage Factors [Earned Premium to Average Surplus], Data from the 2007 Edition of AM Best's Aggregates and Averages [Rounded to the Nearest Million]."

CDI Study "Underserved Community Earned Exposures for Private Passenger Auto and Homeowner s Insurance."

CDI study "Calculation of Average Insurer Line Concentration."

CDI study “Comparison of Best’s Capital Adequacy Ratio for Average Diversified Insurer v. Monoline Insurer.”

TEXT OF THE PROPOSED REGULATIONS TO BE ADOPTED

The text of the proposed rulemaking is attached.

Dated: April 21, 2008.

STEVE POIZNER
Insurance Commissioner

By: /s/
Lara Sweat
Senior Staff Counsel

DEPARTMENT OF INSURANCE**Legal Division, Rate Enforcement Bureau**

45 Fremont Street

21st Floor

San Francisco, CA 94105



**PROPOSED CHANGES TO THE PRIOR APPROVAL
REGULATIONS SET FORTH IN
TITLE 10, CALIFORNIA CODE OF REGULATIONS,
SUBCHAPTER 4.8 SECTIONS 2642.6 – 2644.27**

REG-2007-00046

April 21, 2008

§2642.6. Recorded Period.

"Recorded period" means the historical period from which data are taken to provide the basis for the proposed rate. The recorded period shall be the most recent three years for which reliable data are available, unless

(1) the credibility of that experience is less than the value contained in section 2644.23(gi). In that case, additional years shall be added to the recorded period until sufficient years are used to reach the credibility standard set forth in section 2644.23(gi). In no case shall the recorded period exceed ~~ten~~ six years.

(2) the data is fully credible with fewer than three years experience. In that case, only as many years as needed to be fully credible shall be used.

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.

§2642.7. Lines of Insurance.

(a) Wherever in this subchapter insurance is required to be classified by line, the classification shall be into one of the following categories:

- (1) Fire
- (2) Allied Lines
- (3) Farmowners multiple peril
- (4) Homeowners multiple peril
- (5) Commercial multiple peril liability
- (6) Commercial multiple peril non-liability
- (7) Inland marine
- (8) Medical malpractice
- (9) Earthquake
- (10) Other liability
- (11) Products liability
- (12) Private passenger automobile liability
- (13) Private passenger automobile physical damage
- (14) Commercial automobile liability
- (15) Commercial automobile physical damage
- (16) Aircraft

(17) Fidelity

(18) Surety

(189) Burglary and theft

(1920) Boiler and machinery.

(b) For purposes of this subchapter, mechanical breakdown and similar insurance covering loss caused by the failure or malfunction of a component or system of a motor vehicle, as described in California Insurance Code Section 116(c), shall be classified as other liability occurrence.

(c) Any insurer or the Commissioner may disaggregate any of the foregoing lines, except homeowners multiple peril, private passenger automobile liability, and private passenger automobile physical damage, into two subcategories, "commodity" and "specialty." Rates for specialty insurance shall be approved or disapproved using the most sound actuarial method, consistent with California law, in accordance with the Actuarial Standards of Practice, and relevant and accepted actuarial principles, guidelines, and literature.

(d) Specialty insurance shall include:

(1) Any single policy having an annual premium over \$75,000;

(2) Any policy having a deductible or self-insured retention of \$100,000 or more;

(3) Any excess property, excess liability, or umbrella policy, where none of the underlying policies include private passenger automobile liability, private passenger automobile physical damage, or homeowners coverage, or where the underlying policy is written by an unaffiliated insurer and covers at least the first \$500,000 in losses;

(4) All policies for

(A) nuclear risks,

(B) pollution legal liability,

(C) product-tampering, product impairment, or product recall,

(D) kidnap and ransom,

(E) political risks,

(F) directors' and officers' liability,

(G) boiler and machinery insurance,

(H) fidelity insurance,

(I) mortgage guaranty insurance,

(J) employer liability under the United States Longshoremen's and Harbor Workers' Compensation Act (33 U.S.C. section 901 et seq.), the Jones Act (46 U.S.C. section 688), the Federal Employer Liability Act (45 U.S.C. section 51 et. seq.), or any similar statute,

(K) excess employer's liability over workers' compensation insurance; and,

(L) Differences in conditions coverage;

(M) surety,

(N) credit, and

(O) aviation.

(e) Commodity insurance shall include all policies in the line that are not defined in this section as specialty.

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.

§2642.8. Most Actuarially Sound

The “most actuarially sound” choice is the most appropriate choice within the range of permissible actuarially sound choices, considering both the relative likelihood of all choices within the range and the context in which the choice will be employed.

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.

§2644.2. Maximum Permitted Earned Premium.

The maximum permitted earned premium is calculated as follows:

- (a) the quotient of
 - (1) the sum of
 - (A) (i) projected losses, as defined in section 2644.4,
 - (2)-(ii) plus projected defense and cost containment expenses, as defined in section 2644.8,
 - (B) multiplied by 1 minus the fixed investment income factor as defined in section 2644.19(a),
 - (32) minus projected ancillary income, as defined in section 2644.13,
 - (4) minus fixed investment income, as defined in section 2644.19(a),
 - (b) divided by the maximum denominator, as defined in section 2644.2(c).

Stated as a formula:

$$\text{Max Permitted EP} = \frac{\text{losses} + \text{DCCE} - \text{ancil income} - \text{fixed invest inc}}{\text{max denom}}$$

$$\text{Max Permitted EP} = \frac{(\text{losses} + \text{DCCE}) \times (1 - \text{fixed invest inc factor}) - \text{ancil income}}{\text{max denom}}$$

(c) The maximum denominator means:

- (1) 1.0,
- (2) minus the efficiency standard, as defined in section 2644.12,
- (3) minus the maximum profit factor, as defined in section 2644.15,
- (4) plus the variable investment income factor, as defined in section 2644.19(b).

Stated as a formula:

$$\text{Max denom} = 1 - \text{eff std} - \text{profit factor} + \text{var invest inc factor}$$

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.

§ 2644.3. Minimum Permitted Earned Premium.

The minimum permitted earned premium is calculated as follows:

- (a) the quotient of
 - (1) the sum of

(A)(i) projected losses, as defined in section 2644.4,
~~-(2) (ii) plus projected defense and cost containment expenses, as defined in section 2644.8,~~
(B) multiplied by 1 minus the fixed investment income factor as defined in section 2644.19(a),
~~(3) minus projected ancillary income, as defined in section 2644.13,~~
~~-(4) minus fixed investment income, as defined in section 2644.19(a),~~
 (b) divided by the minimum denominator, as defined in section 2644.3(c).

Stated as a formula:

$$\frac{\text{Min Permitted EP} - \text{losses} + \text{DCCE} - \text{ancil income} - \text{fixed invest inc.}}{\text{min denom}}$$

$$\text{Min Permitted EP} = \frac{(\text{losses} + \text{DCCE}) \times (1 - \text{fixed invest factor}) - \text{ancil income}}{\text{min denom}}$$

(c) The minimum denominator means:

- (1) 1.0,
- (2) minus the efficiency standard, as defined in section 2644.12,
- (3) minus the minimum profit factor, as defined in section 2644.15,
- (4) plus the variable investment income factor, as defined in section 2644.19(b).

Stated as a formula:

$$\text{Min denom} = 1 - \text{eff std.} - \text{profit factor} + \text{var invest inc factor}$$

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.

§2644.6. Loss Development.

"Loss development" is the process by which reported losses are adjusted for anticipated payout patterns. Loss development shall be presented as a loss-development triangle, based on the dollar-weighted average of the ratios of losses for the three most recent accident-years, policy-years or report-years available for a reporting interval. Filings shall contain both paid losses and case-specific reserves, stated separately. Loss development shall employ either paid losses or the sum of paid losses and case-specific reserves. The insurer shall submit both the factors and ultimate losses or claims for both the paid and incurred loss development and the reported claims and the paid claims development calculations, and shall demonstrate that its selection is the most actuarially ~~reasonable~~ sound. Loss development data shall exclude catastrophes. Where the loss development factors within a given line significantly vary by subline, by size of loss, or by coverage, separate loss development factors shall be calculated in accordance with that evidence.

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.

§2644.7. Loss and Premium Trend

(a) "Loss trend" and "premium trend" is the process by which forces not reflected in historical loss and premium data are expected to affect losses and premiums in the rating period.

(ab) Trend factors shall be based on the exponential curve of best fit. Companies shall file the most recent 8, 12, 16, 20, and 24 quarters of rolling calendar year data excluding catastrophes. The Ppremium and loss trend factors shall be developed using the insurer's most actuarially sound company-specific most recent twelve quarters of rolling calendar year data, excluding catastrophes, for the most recent 8, 12, 16, 20, or 24 quarters. The insurer shall file its rate change application using the single data period that it determines to be the most actuarially sound. 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. Frequency trend shall be calculated as reported or closed claims divided by exposures. Severity trend shall be calculated on paid losses divided by closed claims or total paid losses, including partial payments in previous calendar years, on closed claims divided by closed claims. The insurer shall submit the frequency and severity calculations on ~~both~~ all bases, and shall demonstrate that its selection is the most actuarially ~~reasonable~~ sound. Premium trend factors shall be developed using company-specific premium per exposure data.

(bc) Where the trend factor within a given line significantly varies by subline, by policy limits, by region of the state, or by coverage, separate trend factors shall be calculated in accordance with that evidence.

(ed) For homeowners multiple peril and private passenger automobile liability and physical damage, the standard for full credibility for loss trend shall be 6000 total claims over the same number of quarters as used in subsection (b) 12 quarter period for each form for homeowners and for each coverage for private passenger automobile. Partial credibility shall be the square root of the ratio of the actual number of claims divided by the full credibility standard. For private passenger automobile other than motorcycle, the complement of credibility for loss trend shall be calculated using the latest available California Fast Track paid loss, closed claim count and earned exposure data. The complement shall be based on the exponential curve of best fit to the most recent ~~twelve quarters of rolling calendar year data~~ for the same number of quarters as used in subsection (b). For uninsured and underinsured motorist bodily injury and medical payments coverages, the complement shall use the California Fast Track bodily injury data. For uninsured and underinsured motorist property damage coverages, the complement shall use the California Fast Track property damage data. The Commissioner may modify the result of the calculation from California Fast Track data to take into account factors not reflected in the historical data, pursuant to section 2646.3.

(e) For lines of business other than homeowners multiple peril and private passenger automobile liability and physical damage, the standard for full credibility for loss trend shall be determined using the most actuarially sound method. For lines of business other than private passenger automobile liability and physical damage, the standard for the complement of credibility for loss trend shall be determined using the most actuarially sound method.

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.

§2644.8. Projected Defense and Cost Containment Expenses.

(a) "Projected defense and cost containment expenses" means the company's historic costs per exposure associated with the defense and cost containment of claims, adjusted for catastrophes, developed and trended in the manner described in sections 2644.5, 2644.6 and 2644.7.

(b) ~~For liability coverages, d~~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 insurer shall demonstrate that its selection is the most actuarially reasonable sound.

(c) ~~Where an insurer or the Commissioner elects to disaggregate a line of insurance into commodity and specialty categories pursuant to section 2642.7, the insurer may, in addition to the computation of projected defense and cost containment expenses specified in this section, tender an alternative computation of projected defense and cost containment expenses for the specialty category, which the Commissioner shall approve if he or she finds the projection to have been made in a sound actuarial manner. For professional liability and errors and omissions coverage, the insurer shall tender an alternative computation of projected defense and cost containment expenses, which the Commissioner shall approve if he or she finds the projection to have been made in the most sound actuarial manner. Nothing in this section precludes the Commissioner from requiring the additional filing of projected defense and cost containment expenses computed in the manner specified in sections (a) and (b).~~

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.

§2644.11. Expense Trend

§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 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 efficiency standard shall be calculated as the arithmetic average of the latest three years for which data are available.

(d) For farmowners, the efficiency standard for captive insurers shall be the average for all distribution systems combined.

(e) For earthquake, the 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.

(dg) In each category, the efficiency standard shall be set at 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.

(eh) 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.

(fi) 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%.

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

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

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

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

(kn) 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.

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.

§2644.17. Leverage Factor and Surplus.

(a) "Leverage factor" means the ratio of earned premiums to the average of year-beginning and year-end surplus.

(b) 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 factors shall be calculated using the consolidated underwriting and investment exhibit as published in Best's

Aggregates and Averages. The allocation of the commercial multiple peril data to liability and non-liability and the allocation of the automobile physical damage data to private passenger and commercial shall be done using data from the Exhibit of Premiums and losses (Statutory Page 14 Data) as published in Best's Aggregates and Averages. For medical malpractice, other liability and product liability, there shall be separate leverage factors for claims-made and occurrence. Total national industry surplus shall be allocated to lines of business in proportion to the sum of the national industry-wide earned premium, unearned premium, loss and loss adjustment expense reserves. The leverage factor for each line of business shall be the national premium divided by the allocated surplus.

Notwithstanding the result of the calculation, the leverage factor for earthquake shall be 1.0. For other lines of business subject to catastrophes, mass torts and other unusual events, the Commissioner shall modify the leverage factors where he finds that they do not provide a reliable estimate of future risk, pursuant to section 2646.3.

(c) The Commissioner finds that investors' perceived investment risk may vary from line to line. Thus, while the rate of return does not vary by line, insurance perceived to have a greater risk will yield higher returns per premium dollar.

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.

§2644.19. Investment Income Factors.

(a) "Fixed investment income factor" means the projected yield, as defined in section 2644.20,

(1) multiplied by the ratio of the investment federal income tax factor and the underwriting federal income tax factor, as defined in section 2644.18,

(2) multiplied by the loss reserves ratio, as defined in section 2644.21,

~~(3) multiplied by the sum of~~

~~(A) the projected losses, as defined in section 2644.4,~~

~~(B) plus the projected defense and cost containment expenses, as defined in section 2644.8.~~

Stated as a formula:

$$\frac{\text{Fixed invest inc} = \text{yield} \times \frac{\text{FIT inv inc} \times \text{loss reserves ratio} \times (\text{loss} + \text{DCCE})}{\text{FIT und}}}{}$$

$$\frac{\text{Fixed invest inc factor} = \text{yield} \times \frac{\text{FIT inv inc} \times \text{loss reserves ratio}}{\text{FIT und}}}{}$$

(b) "Variable investment income factor" means the projected yield, as defined in section 2644.20,

(1) multiplied by the ratio of the investment federal income tax factor and the underwriting federal income tax factor, as defined in section 2644.18,

(2) multiplied by the sum of

(A) the unearned premium reserves ratio, as defined in section 2644.21,

(B) plus the surplus ratio, as defined in section 2644.22.

Stated as a formula:

$$\text{Var invest inc factor} = \text{yield} \times \frac{\text{FIT}_{\text{inv inc}}}{\text{FIT}_{\text{und}}} \times (\text{uep reserves ratio} \mp \pm \text{surplus ratio})$$

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.

§2644.20. Projected Yield.

(a) "Projected yield" means the weighted average yield computed using the insurer's actual portfolio and yields currently available on securities in US capital markets. The weights shall be determined using the insurer's most recent consolidated statutory annual statement, and shall be computed by dividing the insurer's assets in each separate asset class shown on page 2, lines 1 through 9 of the insurer's consolidated statutory annual statement, by the total of lines 1 through 9. The yields for each asset class shall be based on an average of the most recent available 3 complete months, as of the date of filing.

(b) The bond asset class shall be subdivided into the issuer categories of US government bonds, other taxable bonds and tax exempt bonds and into the maturity categories of short, intermediate and long-term shown. For the purposes of this section, "US government" means the sum of rows 1.7, U.S. governments, and 2.7, all other governments, of schedule D, part 1A, section 1 of the insurer's consolidated statutory annual statement, "other taxable" means the sum of rows 6.7, public utilities, 7.7, industrial and miscellaneous, 8.7, credit tenant loans, 9.7, parent subsidiaries and affiliates and half of row 5.7, special revenue and special assessments and "tax-exempt" means the sum of rows 3.7, states, territories and possessions, 4.7, political subdivision of states, territories and possessions, and half of row 5.7. For the purposes of this section, "short-term" means one year or less, "intermediate-term" means more than one year through 10 years, and "long-term" means more than 10 years.

(c) "Yields currently available on securities in US capital markets" means,

(1) US government bonds

(A) Short: yield on the nominal 3-month constant maturity US Treasury bill as provided in the Federal Reserve H.15 statistical release

(B) Intermediate: yield on the nominal 10-year constant maturity US Treasury bond as provided in the Federal Reserve H.15 statistical release

(C) Long: yield on the nominal 20-year constant maturity US Treasury bond as provided in the Federal Reserve H.15 statistical release

(2) Other taxable bonds

(A) Short: yield on 3-month financial commercial paper as provided in the Federal Reserve H.15 statistical release

(B) Intermediate: average yield on 10-year corporate A and AA rated bonds as provided by Valu/Bond on Yahoo.com

(C) Long: average yield on 20-year corporate A and AA rated bonds as provided by Valu/Bond on Yahoo.com

(3) Tax exempt bonds

(A) Short: yield on short-term other taxable bonds times 1 minus the federal income tax rate of 35%

(B) Intermediate: average yield on 10-year municipal A and AA rated bonds as provided by Valu/Bond on Yahoo.com

(C) Long: average yield on 20-year municipal A and AA rated bonds as provided by Valu/Bond on Yahoo.com

(4) Common stock

(A) Dividends: ten-year average income return as provided in the Ibbotson yearbook

(B) Capital gains: the risk-free rate, below, plus 8%, which the Commissioner finds represents the risk-premium for common stock investments generally, minus dividends, above

(5) Preferred stock dividends: average yield on Moody's A-rated public utility preferred stocks as provided by Mergent Bond Record

(6) Mortgage loans: yield on long-term other taxable bonds, above

(7) Real estate: the risk-free rate, below, plus 2%, which the Commissioner finds represents the risk-premium for real estate investments

(8) Cash and short term: yield on short-term US Treasury bills, above

(9) Other: yield on common stock, above

(d) The "risk-free rate" means the average of the short, intermediate and long-term US government bonds, above, except that the short-term shall be one month instead of three and the intermediate term shall be five years instead of ten.

(e) The projected yield shall be reduced by the ratio of incurred investment expenses, page 11, line 25, column 3, of the insurer's consolidated statutory annual statement, divided by the total of cash and invested assets, page 2, line 10.

(f) The projected yield shall be multiplied by the ratio of cash and invested assets, page 2, line 10 of the insurer's consolidated statutory annual statement, divided by the sum of reserves, page 3, lines 1, 3 and 9, and surplus, page 3, line 35.

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.

§2644.21. Reserves Ratio.

(a) "Unearned premium reserves ratio" means

(1) the average of the last two years ending unearned premium reserves

(2) divided by the earned premium for the most recent year for which data are available.

(b) "Loss reserves ratio" means

(1) the average of the last two years ending

(A) loss reserves plus

(B) loss adjustment expense reserves

(2) divided by the incurred loss and defense and cost containment expense for the most recent year for which data are available.

(c) For burglary and theft, the loss reserve ratio shall be the dollar-weighted average of the loss reserve ratios for fire, allied lines and inland marine.

There shall be one industry-wide unearned premium reserves ratio and one loss reserves ratio for each line of business. The industry-wide numbers shall be the sum of all such numbers taken from the California state page of the statutory annual statement for all insurers doing business in California. Countrywide adjusting and other expense reserves from Best's Aggregates & Averages shall be allocated to California by loss and defense and cost containment reserves. For medical malpractice, other liability and products liability, California premium and reserves

shall be allocated between occurrence and claims-made using countrywide numbers from Best's Aggregates & Averages. The Commissioner shall perform the calculation within 45 days of the publication of the necessary source data. Notwithstanding the result of the calculation, the loss reserves ratio for earthquake shall be 1.0. 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.

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.

§2644.23. Credibility Adjustment.

(a) To the extent that the maximum and minimum permitted earned premiums are based upon data that lack credibility, a credibility adjustment shall be made.

(b) For each form for homeowners multiple peril and for each coverage for private passenger auto liability and physical damage the standard for full credibility shall be 3000 claims. Partial credibility shall be the square root of the ratio of the actual number of incurred claims in the experience period divided by the full credibility standard. For lines of business other than homeowners multiple peril and private passenger automobile liability and physical damage, the standard for full and partial credibility shall be determined using the most actuarially sound method.

(c) When the loss and defense and cost containment expense data is less than fully credible, in the maximum and minimum premium formulas in sections 2644.2 and 2644.3, the following shall be substituted:

- (1) The sum of
 - (A) the credibility weight, as defined in section 2644.23(b),
 - (B) multiplied by the sum of
 - (i) projected loss, as defined in section 2644.4,
 - (ii) plus projected defense and cost containment expense, as defined in section 2644.8,
- (2) plus
 - (A) the difference of
 - (i) 1.0
 - (ii) minus the credibility weight, as defined in section 2644.23(b),
 - (B) multiplied by the complementary loss and defense cost containment expense, as defined in section 2644.23(d).

Stated as a formula:

$$\text{Credibility weight} \times (\text{loss} + \text{DCCE}) + (1 - \text{credibility weight}) \times \text{comp loss DCCE}$$

(d) The complementary loss and defense and cost containment expense means

(1) the quotient ~~product~~ of

(A) the sum of

- (i) the trended current rate level premium, as defined in section 2644.24,
- (ii) multiplied by 1.0 plus the complement trend, as defined in section 2644.23(eg),
- (iii) multiplied by the maximum denominator, as defined in section 2644.2(c).

(2B) plus the sum of

(i) the ancillary income, as defined in section 2644.13, and
 (ii) divided by 1 minus the fixed investment income factor, as defined in section 2644.19.

Stated as a formula:

Comp loss DCCE = (TCRLP x (1 + comp trend) x max denom + ancil income) ÷ (1 - fixed invest inc factor)

(e) Where the cost of reinsurance is allowed, as provided in section 2644.25, the credibility adjustment in subsection (c) shall be made to loss plus defense and cost containment expense minus reinsurance recoverable, as defined in section 2644.26.

(f) Where the cost of reinsurance is allowed, as provided in section 2644.25, the complementary loss and defense and cost containment expense means

(1) The quotient of

(A) The sum of

(I) the trended current rate level premium, as defined in section 2644.24,

(ii) multiplied by 1.0 plus the complement trend, as defined in section 2644.23(g),

(iii) Multiplied by the maximum denominator, as defined in section 2644.2(c).

(B) plus the ancillary income, as defined in section 2644.13,

(C) Minus the product of

(I) the reinsurance premium, as used in section 2644.25, divided by 1 minus the variable expense factor, as defined in section 2644.14,

(ii) multiplied by the maximum denominator, as defined in section 2644.2(c),

(2) Divided by 1 minus the fixed investment income factor, as defined in section 2644.19.

Stated as a formula:

Comp loss DCCE = (TCRLP x (1 + comp trend) x max demon + ancil income - reins perm / (1 - vary exp factor) x max demon) / (1 - fixed invest inc factor)

(eg) The complement trend means the annual net trend plus one, raised to the power of the number of years from the effective date of the current rate to the proposed effective date of the proposed rates, minus one.

Stated as a formula:

Comp trend = ((annual net trend + 1) ^ number of years) - 1

If the number of years from the effective date of the current rate to the proposed effective date of the proposed rates exceeds four, the complement trend shall be the annual net trend plus one, raised to the fourth power, minus one.

(fh) The annual net trend is the ratio of the loss trend, as defined in section 2644.7, annualized, plus one, divided by the premium trend, as defined in section 2644.7, annualized, plus one, minus one.

Stated as a formula:

Annual net trend = ((annual loss trend + 1) / (annual premium trend + 1)) - 1

(~~g~~i) If the credibility weight is less than 25% the applicant or the Commissioner may use an alternative complementary loss and defense and cost containment expense, provided that the alternative is the most actuarially sound method and reasonable in the circumstance.

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.

§2644.25. Reinsurance.

(a) For all lines and sublines except for those listed in the next subparagraph, ratemaking shall be on a direct basis, with no consideration for the cost or benefits of reinsurance.

(b) For earthquake and for medical malpractice facultative reinsurance with attachment points above one million dollars, the maximum permitted earned premium is calculated as follows:

(1) The sum of
~~(A)~~(1) the quotient of
 (A) the difference of
 (i) the product of
 (a) the projected losses, as defined in section 2644.4, (ii) plus the projected defense and cost containment expense, as defined in section 2644.8, (iii) minus the projected reinsurance recoverables, as defined in section 2644.26,

(b) multiplied by 1 minus the fixed investment income factor, as defined in section 2644.19(a),

~~(iv ii)~~ minus the projected ancillary income, as defined in section 2644.13,
~~(v) minus the fixed investment income, as defined in section 2644.19(a),~~
~~(B)-(B)~~ divided by the sum of
 (i) 1.0,
 (ii) minus the efficiency standard, as defined in section 2644.12,
 (iii) minus the maximum profit factor, as defined in section 2644.15,
 (iv) plus the variable investment income factor, as defined in section 2644.19(b).
 (2) plus the quotient of
 (A) the reinsurance premium, net of ceding and contingent commissions,
 (B) divided by the difference of
 (i) 1.0,
 (ii) minus the variable expense factor, as defined in section 2644.14.

Stated as a formula:

$$\frac{\text{Max permitted EP} - \text{losses} + \text{DCCE} - \text{recoverables} - \text{ancil income} - \text{fixed invest inc} + \text{reins premium}}{1 - \text{eff std} - \text{profit factor} + \text{var invest inc factor} - 1 - \text{var exp factor}}$$

$$\text{Max permitted EP} = \frac{(\text{losses} + \text{DCCE} - \text{recoverables}) \times (1 - \text{fixed invest income factor}) - \text{ancil inc.} + \text{reins premium}}{1 - \text{eff std} - \text{profit factor} + \text{var invest inc factor} - 1 - \text{var exp factor}}$$

(c) For the calculation of fixed investment income factor, the numerator and denominator of the loss reserves ratio shall be adjusted for projected reinsurance recoverables, and for the

variable investment income factor, the numerator and denominator of the unearned premium reserve ratio shall be adjusted to reflect the cash flows of the unearned reinsurance premium.

(d) Reinsurance costs shall ~~only~~ be allowed for ratemaking purposes as set forth in this section only if: (1) the reinsurance agreement was entered into in good faith in an arms-length transaction and at fair market value for the coverage provided, and (2) the reinsurance meets the statement credit requirements of Sections 2303 through 2303.25. Additionally, there must be an acceptable transfer of risk, and the reinsurance must comply with all applicable Statutory Accounting Principles.

(e) There will be no allowance for reinsurance between affiliated entities as set forth in Schedule Y of the Annual Statement.

~~(f) There will be no allowance for reinsurance through unauthorized reinsurers.~~

~~(g)~~ Copies of the reinsurance agreements shall be submitted with the filing.

~~(h)~~ For the purposes of this section and section 2644.26, reinsurance shall include other risk financing mechanisms, such as catastrophe bonds.

~~(i)~~ For the earthquake line, if at least 30% of the requested rate results from the cost of reinsurance, and a consumer or his or her representative requests a hearing within 45 days of public notice, the Commissioner shall hold a hearing on the issue of the reasonableness of the reinsurance costs, as defined in section (d), and whether some or all of those costs shall be reflected in the proposed rate change. An insurer's rate application shall indicate whether at least 30% of the requested rate results from the cost of reinsurance.

~~(j)~~ For the medical malpractice line, if at least 30% of the requested rate is attributable to the cost of facultative reinsurance with attachment points above one million dollars, and a consumer or his or her representative requests a hearing within 45 days of public notice, the Commissioner shall hold a hearing on the issue of the reasonableness of the reinsurance costs, as defined in section (d), and whether some or all of those costs shall be reflected in the proposed rate change. An insurer's rate application shall indicate whether at least 30% of the requested rate results from the cost of reinsurance.

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 ~~Form CA-RA9~~ 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 ~~efficiency standard, rate of return, loss development factors or trend which will result if the variance is granted~~ 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 ~~in the applicable efficiency standard, rate of~~

return, loss development factors or trend that is being proposed 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:

(1) 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

(2) 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 will alter its mix of business in the rating period from the mix in the recorded period in a manner that affects the maximum and minimum permitted earned premium. Any such representation by the insurer shall specify the precise changes in business operations, shall be supported by a statement of an authorized official of the insurer indicating the manner in which the insurer plans to implement the change, and shall include such substantiating information as the Commissioner may require, including but not limited to specification of changes in the insurer's marketing program and relevant market research. Such representation shall be accompanied by the stipulation by the insurer to refund to consumers in a subsequent rate case if the change fails to materialize.~~

~~(2) That the insurer should be allowed to recover additional costs relief from the efficiency standard for bona fide loss-prevention and loss-reduction activities, provided the insurer can demonstrate loss reductions commensurate with the increased expenditures 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 Total 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 Cost 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.

(32) That the insurer should be allowed a ~~higher or lower~~ relief from the efficiency standard due to any or all of the following:

(A) ~~higher or lower~~ Superior quality of service, as demonstrated by external objective measures of consumer satisfaction; ~~or~~ such as the J.D. Power Ratings, or the California Department of Insurance Consumer Complaint Study. An insurer rated in the J.D. Power

National Study will qualify for this variance only if it is rated as “among the best” or “better than most” in “overall experience.”

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

(i) Underserved Communities means those communities which the Commissioner has determined are underserved as set forth in the “Commissioner’s Report on Underserved Communities.”

(ii) Superior is defined as those insurers whose percentage of total earned exposures in underserved communities are in the top 25% weighted by exposure of insurers.

(C) significantly smaller or larger than average California policy size 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.

(D) The relief allowed for a variance based on subsections (A) or (B) shall be limited to 2% for each.

~~(43) That the insurer should be allowed a higher or lower return on equity due to higher or lower financial investment in underserved communities, as defined in section 2646.6.~~

(5) That the insurer should be authorized a rate of return leverage factor different from the rate of return leverage factor determined pursuant to section 2644.167 on the ground 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.

(64) 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.

(75) 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.

(86) 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.

(97) That the loss development formula in section 2644.6 does not produce an 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.

(108) That the trend formula in section 2644.7 does not produce an 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;
- (BC) There is a significant change in the law affecting the frequency or severity of claims;

(ED) It can be shown that a trends calculated over a period of at least a 10-year period 4 quarters other than a period permitted pursuant to section 2644.7(b) are is more reliable prospectively;

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

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

(119) 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. 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.

EXHIBIT E

DEPARTMENT OF INSURANCE

Legal Division, Rate Enforcement Bureau
45 Fremont Street, 21st Floor
San Francisco, CA 94105



**NOTICE OF PROPOSED EMERGENCY ACTION
AND FINDING OF EMERGENCY
PURSUANT TO CALIFORNIA INSURANCE CODE SECTION 12921.7**

REG-2007-00046

April 29, 2008

PRIOR APPROVAL REGULATIONS

California Insurance Commissioner Steve Poizner (the "Commissioner") hereby provides notice, pursuant to California Insurance Code section 12921.7 that he will propose to the Office of Administrative Law ("OAL") the adoption of emergency amendments to the Prior Approval Regulations, referenced in Title 10, Chapter 5, Subchapter 4.8, Article 2, Sections 2642.6, 2642.7, and Article 4 Sections 2644.2, 2644.3, 2644.6, 2644.7, 2644.8, 2644.11, 2644.12, 2644.16, 2644.17, 2644.19, 2644.20, 2644.21, 2644.23, 2644.25, 2644.27 and 2644.28 of the California Code of Regulations, on an emergency basis pursuant to California Government Code section 11346.1(b).

This Notice contains a description of the facts demonstrating the existence of an emergency and the necessity for the regulations, along with a copy of the text of the emergency regulations.

This Notice is provided to every person, group, and association who has previously filed a request for notice of regulatory action with the Commissioner. Copies of the Notice and studies are available at the Department of Insurance, 45 Fremont Street, 21st Floor, San Francisco, California, 94105 and on the Department's web site at www.insurance.ca.gov.

The proposed regulation will be submitted to the Office of Administrative Law together with the rulemaking file not less than five (5) working days after the mailing of this Notice to every person who has filed a request for notice of regulatory action with the Department, as required by California Insurance Code section 12921.7. After submission of the proposed emergency to the Office of Administrative Law, the Office of Administrative Law shall allow interested persons five calendar days to submit comments on the proposed emergency regulations as set forth in Government Code section 11349.6. Questions regarding this Notice should be directed to:

California Department of Insurance
Legal Division
Attn: Lara Sweat, Senior Staff Counsel
45 Fremont Street, 21st Floor
San Francisco, California 94105
(415) 538-4192

The Commissioner hereby finds that an emergency exists, and that the following amendments to the Prior Approval Regulations, referenced in Title 10, Chapter 5, Subchapter 4.8, Article 2, Sections 2642.6, 2642.7, 2642.8 and Article 4 Sections 2644.2, 2644.3, 2644.6, 2644.7, 2644.8, 2644.11, 2644.12, 2644.16, 2644.17, 2644.19, 2644.20, 2644.21, 2644.23, 2644.25, 2644.27 and 2644.28 of the California Code of Regulations, are necessary for the immediate preservation of the public peace, health and safety, or general welfare.

INFORMATIVE DIGEST / POLICY STATEMENT OVERVIEW

Existing law, Proposition 103 (Insurance Code sections 1861.01 *et seq.*), an initiative approved by the California voters on November 8, 1988, establishes a system of prior approval rate regulation for property-casualty insurance lines (except those listed in Insurance Code section 1851). In 1991 the Department adopted regulations which provided a formula to determine whether a rate was excessive or inadequate. These regulations were upheld in *20th Century Insurance Company v. Garamendi* (1994) 8 Cal.4th 216 recognizing that the Department's use of a general formula could help reduce the task of reviewing rate applications to a "manageable size." Each section of these regulations is part of the comprehensive formula used to determine rates. All the sections work together to help determine an appropriate insurance rate, that is, one that is neither excessive nor inadequate.

DESCRIPTION OF PROBLEM AND NECESSITY FOR REGULATION

In 2006, the Department made comprehensive revisions to the prior approval regulations (RH05042749) which were effective in April 2007 (the "2007 revisions"). The 2007 revisions included significant changes to the prior approval regulations including existing variances and the creation of new variances. A variance will allow deviation from the prior approval regulations for certain specified reasons such as lack of data or solvency issues. Variances are crucial to the ratemaking process because they can recognize and allow for the uniqueness of an insurer's experience data by line and program.

The 2007 revisions were intended to simplify the prior approval process and to provide some flexibility in certain situations as warranted by the variances.

Since the 2007 revisions have been in effect, certain issues were identified both by the Department and insurers with regard to the administration of the variances. After these issues were identified, the Department invested considerable time and effort in the development of standards and benchmarks and other revisions to the prior approval regulations which were not able to be addressed in the 2007 revisions.

The goal of this rulemaking is to make necessary changes to the variances and other associated prior approval regulations.

JUSTIFICATION FOR ADOPTION AS EMERGENCY REGULATIONS

Regulations were created as a means to determine whether a rate is excessive or inadequate. The use of regulations for this process was upheld in *20th Century* where the court recognized that regulations providing for a general formula were an appropriate method for managing the number of rate applications. In order for the Department to be able to review the large number

of rate application it receives each year, rules of general application must be in place, thus a regulation.

This rulemaking is necessary to resolve the issues with the variances as well as to address other issues that arose after the 2007 revisions.

Since the revisions went into effect in April 2007, the Department and insurers began to notice certain issues with the administration of the variances. As it became clear that administering the variances was problematic, the Department began to develop amendments to the regulations as well as to other sections of the prior approval regulations that were not able to be addressed during the 2007 revisions or that arose as a result of the 2007 revisions. However, due to the highly technical nature of the prior approval regulations and variances, there was no way to craft a “quick fix.” The proposed regulation changes are a result of several months of study, discussion and refinement as each part of the regulatory scheme is part of a comprehensive formula used to determine rates. The components all work together to complete the calculation for a maximum and minimum permitted earned premium and determine the appropriate rate. Every section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable.

The Department has moved quickly to resolve the issues with the 2007 revisions and regulations and therefore these revisions need to be put into place as soon as possible. The Department has identified a significant decrease in rate applications in 2007. Insurance is multi billion dollar industry, affecting almost every citizen of the state. It is necessary to have an appropriate, properly functioning mechanism for determination of rates.

These regulations need to be enacted on an emergency basis in order to have a fully functioning regulatory scheme. Pursuant to CCR section 2632.11(c)(1), private passenger automobile insurers must fully comply with the 2006 amendments to the automobile rating factor regulations (the “ARFs”) by July 14 of 2008. Insurers are also required to file rate applications with the class plan.

If these regulations are not enacted on an emergency basis, changes to rates, specifically prior passenger automobile rates, will occur in two parts, the first with the ARF filing and then further changes pursuant to these revisions as the ARF deadline is earlier than the regular rulemaking process deadline. In order to harmonize both regulatory schemes, these amendments must be implemented before the ARF deadline. Accordingly, the Commissioner must utilize the emergency regulations procedures; otherwise the coverage and rate changes to be implemented via the ARF filings will not occur in harmony with rate changes resulting from these revisions.

The only way to immediately protect the public’s interest in this case is if the regulations are adopted on an emergency basis. Requiring insurers to file two rate filings, one right after another, would cause tremendous confusion in the marketplace. As a result insurers will face difficulties implementing their rating plans and insureds may be displaced as insurers implement one rating plan in order to comply with the ARF deadline and then another rating plan to comply with revisions to the prior approval regulations.

California case law supports the Commissioner's decision to promulgate emergency regulations in this instance. In *Schenley Affiliated Brands Corp. v. Kirby* (Cal. Ct. App. 1971) 21 Cal. App.3d 177 the court held that an agency did not abuse its discretion in promulgating emergency regulations where other regulations were about to go into effect and additional regulations were needed in order to achieve a fully operational regulatory scheme.

Lastly the amendments are necessary prior to the ARF filing deadline to allow the Department to handle the large number of filings anticipated. Currently only about twenty percent of private passenger automobile insurers have complied with the ARF deadline which means an influx of filings which the Department will have to review within the statutorily prescribed time frame of 60 days. Without these revisions in place, it will be difficult for the Department to properly review the large number of private passenger automobile filings within the designated time frame. The revised regulations provide clarity with better defined benchmarks and will make the development and submission of the ARF filings less cumbersome and time consuming for both insurers and the Department.

AUTHORITY UNDER WHICH REGULATIONS ARE PROPOSED

These regulations are specifically authorized by California Insurance Code sections 1861.01 and 1861.05. These regulations would implement, interpret or make specific Insurance Code sections 1861.01 and 1861.05.

Because this proposed rulemaking action concerns ratemaking, California Government Code section 11340.9(g) applies.

COMPARABLE FEDERAL LAW

There are no comparable existing federal regulations or statutes.

LOCAL MANDATE DETERMINATION

The Insurance Commissioner has initially determined that the proposal will not result in any new program mandates on local agencies or school districts.

COST OR SAVINGS TO STATE OR LOCAL AGENCIES / SCHOOL DISTRICTS / FEDERAL FUNDING

The Insurance Commissioner has initially determined that the proposal will not result in any cost or significant savings to any state agency or to any local agency or school district for which Part 7 (commencing with section 17500) of Division 4 of the Government Code would require reimbursement, or in other nondiscretionary costs or savings to local agencies. Nor will the proposal affect federal funding to the state.

TECHNICAL STUDIES OR REPORTS RELIED UPON

CDI study "Calculation of Leverage Factors [Earned Premium to Average Surplus], Data from the 2007 Edition of AM Best's Aggregates and Averages [Rounded to the Nearest Million]."

CDI Study “Underserved Community Earned Exposures for Private Passenger Auto and Homeowner s Insurance.”

CDI study “Calculation of Average Insurer Line Concentration.”

CDI study “Comparison of Best’s Capital Adequacy Ratio for Average Diversified Insurer v. Monoline Insurer.”

TEXT OF THE PROPOSED REGULATIONS TO BE ADOPTED

The text of the proposed rulemaking is attached.

Dated: April 29, 2008.

STEVE POIZNER
Insurance Commissioner

By: _____
Lara Sweat
Senior Staff Counsel

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

PROPOSED TEXT

DATE: April 29, 2008

REGULATION FILE: REG-2007-00046

Title 10 Subchapter 4.8

§2642.6. Recorded Period.

"Recorded period" means the historical period from which data are taken to provide the basis for the proposed rate. The recorded period shall be the most recent three years for which reliable data are available, unless

(1) the credibility of that experience is less than the value contained in section 2644.23(gi). In that case, additional years shall be added to the recorded period until sufficient years are used to reach the credibility standard set forth in section 2644.23(gi). In no case shall the recorded period exceed ~~ten~~ six years.

(2) the data is fully credible with fewer than three years experience. In that case, only as many years as needed to be fully credible shall be used.

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.

§2642.7. Lines of Insurance.

(a) Wherever in this subchapter insurance is required to be classified by line, the classification shall be into one of the following categories:

- (1) Fire
- (2) Allied Lines
- (3) Farmowners multiple peril
- (4) Homeowners multiple peril
- (5) Commercial multiple peril liability
- (6) Commercial multiple peril non-liability
- (7) Inland marine
- (8) Medical malpractice
- (9) Earthquake
- (10) Other liability
- (11) Products liability
- (12) Private passenger automobile liability
- (13) Private passenger automobile physical damage
- (14) Commercial automobile liability
- (15) Commercial automobile physical damage
- (16) Aircraft
- (17) Fidelity

(18) Surety

(189) Burglary and theft

(1920) Boiler and machinery.

(b) For purposes of this subchapter, mechanical breakdown and similar insurance covering loss caused by the failure or malfunction of a component or system of a motor vehicle, as described in California Insurance Code Section 116(c), shall be classified as other liability occurrence.

(c) Any insurer or the Commissioner may disaggregate any of the foregoing lines, except homeowners multiple peril, private passenger automobile liability, and private passenger automobile physical damage, into two subcategories, "commodity" and "specialty." Rates for specialty insurance shall be approved or disapproved using the most sound actuarial method, consistent with California law, in accordance with the Actuarial Standards of Practice, and relevant and accepted actuarial principles, guidelines, and literature.

(d) Specialty insurance shall include:

(1) Any single policy having an annual premium over \$75,000;

(2) Any policy having a deductible or self-insured retention of \$100,000 or more;

(3) Any excess property, excess liability, or umbrella policy, where none of the underlying policies include private passenger automobile liability, private passenger automobile physical damage, or homeowners coverage, or where the underlying policy is written by an unaffiliated insurer and covers at least the first \$500,000 in losses;

(4) All policies for

(A) nuclear risks,

(B) pollution legal liability,

(C) product-tampering, product impairment, or product recall,

(D) kidnap and ransom,

(E) political risks,

(F) directors' and officers' liability,

(G) boiler and machinery insurance,

(H) fidelity insurance,

(I) mortgage guaranty insurance,

(J) employer liability under the United States Longshoremen's and Harbor Workers' Compensation Act (33 U.S.C. section 901 et seq.), the Jones Act (46 U.S.C. section 688), the Federal Employer Liability Act (45 U.S.C. section 51 et. seq.), or any similar statute,

(K) excess employer's liability over workers' compensation insurance; and,

(L) Differences in conditions coverage;

(M) surety,

(N) credit, and

(O) aviation.

(e) Commodity insurance shall include all policies in the line that are not defined in this section as specialty.

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.

§2642.8. Most Actuarially Sound

The “most actuarially sound” choice is the most appropriate choice within the range of permissible actuarially sound choices, considering both the relative likelihood of all choices within the range and the context in which the choice will be employed.

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.

§2644.2. Maximum Permitted Earned Premium.

The maximum permitted earned premium is calculated as follows:

- (a) the quotient of
 - (1) the sum of
 - (A) (i) projected losses, as defined in section 2644.4,
 - (2)-(ii) plus projected defense and cost containment expenses, as defined in section 2644.8,
 - (B) multiplied by 1 minus the fixed investment income factor as defined in section 2644.19(a),
 - (32) minus projected ancillary income, as defined in section 2644.13,
 - (4) minus fixed investment income, as defined in section 2644.19(a),
 - (b) divided by the maximum denominator, as defined in section 2644.2(c).

Stated as a formula:

$$\text{Max Permitted EP} = \frac{\text{losses} + \text{DCCE} - \text{ancil income} - \text{fixed invest inc}}{\text{max denom}}$$

$$\text{Max Permitted EP} = \frac{(\text{losses} + \text{DCCE}) \times (1 - \text{fixed invest inc factor}) - \text{ancil income}}{\text{max denom}}$$

(c) The maximum denominator means:

- (1) 1.0,
- (2) minus the efficiency standard, as defined in section 2644.12,
- (3) minus the maximum profit factor, as defined in section 2644.15,
- (4) plus the variable investment income factor, as defined in section 2644.19(b).

Stated as a formula:

$$\text{Max denom} = 1 - \text{eff std} - \text{profit factor} + \text{var invest inc factor}$$

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.

§ 2644.3. Minimum Permitted Earned Premium.

The minimum permitted earned premium is calculated as follows:

- (a) the quotient of
 - (1) the sum of

(A)(i) projected losses, as defined in section 2644.4,
~~-(2) (ii) plus projected defense and cost containment expenses, as defined in section 2644.8,~~
(B) multiplied by 1 minus the fixed investment income factor as defined in section 2644.19(a),
~~(32) minus projected ancillary income, as defined in section 2644.13,~~
~~-(4) minus fixed investment income, as defined in section 2644.19(a);~~
 (b) divided by the minimum denominator, as defined in section 2644.3(c).

Stated as a formula:

$$\frac{\text{Min Permitted EP} - \text{losses} + \text{DCCE} - \text{ancil income} - \text{fixed invest inc.}}{\text{min denom}}$$

$$\text{Min Permitted EP} = \frac{(\text{losses} + \text{DCCE}) \times (1 - \text{fixed invest factor}) - \text{ancil income}}{\text{min denom}}$$

(c) The minimum denominator means:

- (1) 1.0,
- (2) minus the efficiency standard, as defined in section 2644.12,
- (3) minus the minimum profit factor, as defined in section 2644.15,
- (4) plus the variable investment income factor, as defined in section 2644.19(b).

Stated as a formula:

$$\text{Min denom} = 1 - \text{eff std.} - \text{profit factor} + \text{var invest inc factor}$$

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.

§2644.6. Loss Development.

"Loss development" is the process by which reported losses are adjusted for anticipated payout patterns. Loss development shall be presented as a loss-development triangle, based on the dollar-weighted average of the ratios of losses for the three most recent accident-years, policy-years or report-years available for a reporting interval. Filings shall contain both paid losses and case-specific reserves, stated separately. Loss development shall employ either paid losses or the sum of paid losses and case-specific reserves. The insurer shall submit both the factors and ultimate losses or claims for both the paid and incurred loss development and the reported claims and the paid claims development calculations, and shall demonstrate that its selection is the most actuarially reasonable sound. Loss development data shall exclude catastrophes. Where the loss development factors within a given line significantly vary by subline, by size of loss, or by coverage, separate loss development factors shall be calculated in accordance with that evidence.

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.

§2644.7. Loss and Premium Trend

(a) "Loss trend" and "premium trend" is the process by which forces not reflected in historical loss and premium data are expected to affect losses and premiums in the rating period.

(ab) Trend factors shall be based on the exponential curve of best fit. Companies shall file the most recent 8, 12, 16, 20, and 24 quarters of rolling calendar year data excluding catastrophes. The ~~P~~premium and loss trend factors shall be developed using the insurer's most actuarially sound company-specific ~~most recent twelve quarters of rolling calendar year data,~~ excluding catastrophes, for the most recent 8, 12, 16, 20, or 24 quarters. The insurer shall file its rate change application using the single data period that it determines to be the most actuarially sound. 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. Frequency trend shall be calculated as reported or closed claims divided by exposures. Severity trend shall be calculated on paid losses divided by closed claims or total paid losses, including partial payments in previous calendar years, on closed claims divided by closed claims. The insurer shall submit the frequency and severity calculations on ~~both~~ all bases, and shall demonstrate that its selection is the most actuarially ~~reasonable~~ sound. Premium trend factors shall be developed using company-specific premium per exposure data.

(bc) Where the trend factor within a given line significantly varies by subline, by policy limits, by region of the state, or by coverage, separate trend factors shall be calculated in accordance with that evidence.

(ed) For homeowners multiple peril and private passenger automobile liability and physical damage, the standard for full credibility for loss trend shall be 6000 total claims over the same number of quarters as used in subsection (b) ~~12 quarter period~~ for each form for homeowners and for each coverage for private passenger automobile. Partial credibility shall be the square root of the ratio of the actual number of claims divided by the full credibility standard. For private passenger automobile other than motorcycle, the complement of credibility for loss trend shall be calculated using the latest available California Fast Track paid loss, closed claim count and earned exposure data. The complement shall be based on the exponential curve of best fit to the most recent twelve quarters of rolling calendar year data for the same number of quarters as used in subsection (b). For uninsured and underinsured motorist bodily injury and medical payments coverages, the complement shall use the California Fast Track bodily injury data. For uninsured and underinsured motorist property damage coverages, the complement shall use the California Fast Track property damage data. The Commissioner may modify the result of the calculation from California Fast Track data to take into account factors not reflected in the historical data, pursuant to section 2646.3.

(e) For lines of business other than homeowners multiple peril and private passenger automobile liability and physical damage, the standard for full credibility for loss trend shall be determined using the most actuarially sound method. For lines of business other than private passenger automobile liability and physical damage, the standard for the complement of credibility for loss trend shall be determined using the most actuarially sound method.

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.

§2644.8. Projected Defense and Cost Containment Expenses.

(a) "Projected defense and cost containment expenses" means the company's historic costs per exposure associated with the defense and cost containment of claims, adjusted for catastrophes, developed and trended in the manner described in sections 2644.5, 2644.6 and 2644.7.

(b) ~~For liability coverages, d~~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 insurer shall demonstrate that its selection is the most actuarially reasonable sound.

(c) ~~Where an insurer or the Commissioner elects to disaggregate a line of insurance into commodity and specialty categories pursuant to section 2642.7, the insurer may, in addition to the computation of projected defense and cost containment expenses specified in this section, tender an alternative computation of projected defense and cost containment expenses for the specialty category, which the Commissioner shall approve if he or she finds the projection to have been made in a sound actuarial manner.~~ For professional liability and errors and omissions coverage, the insurer shall tender an alternative computation of projected defense and cost containment expenses, which the Commissioner shall approve if he or she finds the projection to have been made in the most sound actuarial manner. Nothing in this section precludes the Commissioner from requiring the additional filing of projected defense and cost containment expenses computed in the manner specified in sections (a) and (b).

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.

§2644.11. Expense Trend

§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 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 efficiency standard shall be calculated as the arithmetic average of the latest three years for which data are available.

(d) For farmowners, the efficiency standard for captive insurers shall be the average for all distribution systems combined.

(e) For earthquake, the 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.

(dg) In each category, the efficiency standard shall be set at 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.

(eh) 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.

(fi) 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%.

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

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

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

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

(kn) 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.

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.

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.

§2644.17. Leverage Factor and Surplus.

(a) "Leverage factor" means the ratio of earned premiums to the average of year-beginning and year-end surplus.

(b) 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 factors shall be calculated using the consolidated underwriting and investment exhibit as published in Best's Aggregates and Averages. The allocation of the commercial multiple peril data to liability and non-liability and the allocation of the automobile physical damage data to private passenger and commercial shall be done using data from the Exhibit of Premiums and losses (Statutory Page 14 Data) as published in Best's Aggregates and Averages. For medical malpractice, other liability and product liability, there shall be separate leverage factors for claims-made and occurrence. Total national industry surplus shall be allocated to lines of business in proportion to the sum of the national industry-wide earned premium, unearned premium, loss and loss adjustment expense reserves. The leverage factor for each line of business shall be the national premium divided by the allocated surplus.

Notwithstanding the result of the calculation, the leverage factor for earthquake shall be 1.0. For other lines of business subject to catastrophes, mass torts and other unusual events, the Commissioner shall modify the leverage factors where he finds that they do not provide a reliable estimate of future risk, pursuant to section 2646.3.

(c) The Commissioner finds that investors' perceived investment risk may vary from line to line. Thus, while the rate of return does not vary by line, insurance perceived to have a greater risk will yield higher returns per premium dollar.

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.

§2644.19. Investment Income Factors.

(a) "Fixed investment income factor" means the projected yield, as defined in section 2644.20,

(1) multiplied by the ratio of the investment federal income tax factor and the underwriting federal income tax factor, as defined in section 2644.18,

(2) multiplied by the loss reserves ratio, as defined in section 2644.21;

~~-(3) multiplied by the sum of~~

~~-(A) the projected losses, as defined in section 2644.4,~~

~~-(B) plus the projected defense and cost containment expenses, as defined in section 2644.8.~~

Stated as a formula:

$$\frac{\text{Fixed invest inc} = \text{yield} \times \frac{\text{FIT inv inc} \times \text{loss reserves ratio} \times (\text{loss} + \text{DCCE})}{\text{FIT und}}}{}$$

$$\frac{\text{Fixed invest inc factor} = \text{yield} \times \frac{\text{FIT inv inc} \times \text{loss reserves ratio}}{\text{FIT und}}}{}$$

(b) "Variable investment income factor" means the projected yield, as defined in section 2644.20,

(1) multiplied by the ratio of the investment federal income tax factor and the underwriting federal income tax factor, as defined in section 2644.18,

(2) multiplied by the sum of

(A) the unearned premium reserves ratio, as defined in section 2644.21,

(B) plus the surplus ratio, as defined in section 2644.22.

Stated as a formula:

$$\text{Var invest inc factor} = \text{yield} \times \frac{\text{FIT inv inc} \times (\text{uep reserves ratio} \pm \text{surplus ratio})}{\text{FIT und}}$$

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.

§2644.20. Projected Yield.

(a) "Projected yield" means the weighted average yield computed using the insurer's actual portfolio and yields currently available on securities in US capital markets. The weights shall be determined using the insurer's most recent consolidated statutory annual statement, and shall be computed by dividing the insurer's assets in each separate asset class shown on page 2, lines 1 through 9 of the insurer's consolidated statutory annual statement, by the total of lines 1 through 9. The yields for each asset class shall be based on an average of the most recent available 3 complete months, as of the date of filing.

(b) The bond asset class shall be subdivided into the issuer categories of US government bonds, other taxable bonds and tax exempt bonds and into the maturity categories of short, intermediate and long-term shown. For the purposes of this section, "US government" means the sum of rows 1.7, U.S. governments, and 2.7, all other governments, of schedule D, part 1A, section 1 of the insurer's consolidated statutory annual statement, "other taxable" means the sum of rows 6.7, public utilities, 7.7, industrial and miscellaneous, 8.7, credit tenant loans, 9.7, parent subsidiaries and affiliates and half of row 5.7, special revenue and special assessments and "tax-exempt" means the sum of rows 3.7, states, territories and possessions, 4.7, political subdivision of states, territories and possessions, and half of row 5.7. For the purposes of this section, "short-term" means one year or less, "intermediate-term" means more than one year through 10 years, and "long-term" means more than 10 years.

(c) "Yields currently available on securities in US capital markets" means,

- (1) US government bonds
 - (A) Short: yield on the nominal 3-month constant maturity US Treasury bill as provided in the Federal Reserve H.15 statistical release
 - (B) Intermediate: yield on the nominal 10-year constant maturity US Treasury bond as provided in the Federal Reserve H.15 statistical release
 - (C) Long: yield on the nominal 20-year constant maturity US Treasury bond as provided in the Federal Reserve H.15 statistical release
- (2) Other taxable bonds
 - (A) Short: yield on 3-month financial commercial paper as provided in the Federal Reserve H.15 statistical release
 - (B) Intermediate: average yield on 10-year corporate A and AA rated bonds as provided by Valu/Bond on Yahoo.com
 - (C) Long: average yield on 20-year corporate A and AA rated bonds as provided by Valu/Bond on Yahoo.com
- (3) Tax exempt bonds
 - (A) Short: yield on short-term other taxable bonds times 1 minus the federal income tax rate of 35%
 - (B) Intermediate: average yield on 10-year municipal A and AA rated bonds as provided by Valu/Bond on Yahoo.com
 - (C) Long: average yield on 20-year municipal A and AA rated bonds as provided by Valu/Bond on Yahoo.com
- (4) Common stock
 - (A) Dividends: ten-year average income return as provided in the Ibbotson yearbook
 - (B) Capital gains: the risk-free rate, below, plus 8%, which the Commissioner finds represents the risk-premium for common stock investments generally, minus dividends, above
- (5) Preferred stock dividends: average yield on Moody's A-rated public utility preferred stocks as provided by Mergent Bond Record
- (6) Mortgage loans: yield on long-term other taxable bonds, above
- (7) Real estate: the risk-free rate, below, plus 2%, which the Commissioner finds represents the risk-premium for real estate investments
- (8) Cash and short term: yield on short-term US Treasury bills, above
- (9) Other: yield on common stock, above
- (d) The "risk-free rate" means the average of the short, intermediate and long-term US government bonds, above, except that the short-term shall be one month instead of three and the intermediate term shall be five years instead of ten.
- (e) The projected yield shall be reduced by the ratio of incurred investment expenses, page 11, line 25, column 3, of the insurer's consolidated statutory annual statement, divided by the total of cash and invested assets, page 2, line 10.
- (f) The projected yield shall be multiplied by the ratio of cash and invested assets, page 2, line 10 of the insurer's consolidated statutory annual statement, divided by the sum of reserves, page 3, lines 1, 3 and 9, and surplus, page 3, line 35.

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.

§2644.21. Reserves Ratio.

- (a) "Unearned premium reserves ratio" means
 - (1) the average of the last two years ending unearned premium reserves
 - (2) divided by the earned premium for the most recent year for which data are available.
- (b) "Loss reserves ratio" means
 - (1) the average of the last two years ending
 - (A) loss reserves plus
 - (B) loss adjustment expense reserves
 - (2) divided by the incurred loss and defense and cost containment expense for the most recent year for which data are available.

(c) For burglary and theft, the loss reserve ratio shall be the dollar-weighted average of the loss reserve ratios for fire, allied lines and inland marine.

There shall be one industry-wide unearned premium reserves ratio and one loss reserves ratio for each line of business. The industry-wide numbers shall be the sum of all such numbers taken from the California state page of the statutory annual statement for all insurers doing business in California. Countrywide adjusting and other expense reserves from Best's Aggregates & Averages shall be allocated to California by loss and defense and cost containment reserves. For medical malpractice, other liability and products liability, California premium and reserves shall be allocated between occurrence and claims-made using countrywide numbers from Best's Aggregates & Averages. The Commissioner shall perform the calculation within 45 days of the publication of the necessary source data. Notwithstanding the result of the calculation, the loss reserves ratio for earthquake shall be 1.0. 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.

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.

§2644.23. Credibility Adjustment.

(a) To the extent that the maximum and minimum permitted earned premiums are based upon data that lack credibility, a credibility adjustment shall be made.

(b) For each form for homeowners multiple peril and for each coverage for private passenger auto liability and physical damage the standard for full credibility shall be 3000 claims. Partial credibility shall be the square root of the ratio of the actual number of incurred claims in the experience period divided by the full credibility standard. For lines of business other than homeowners multiple peril and private passenger automobile liability and physical damage, the standard for full and partial credibility shall be determined using the most actuarially sound method.

(c) When the loss and defense and cost containment expense data is less than fully credible, in the maximum and minimum premium formulas in sections 2644.2 and 2644.3, the following shall be substituted:

- (1) The sum of
 - (A) the credibility weight, as defined in section 2644.23(b),
 - (B) multiplied by the sum of
 - (i) projected loss, as defined in section 2644.4,

- (ii) plus projected defense and cost containment expense, as defined in section 2644.8,
- (2) plus
- (A) the difference of
- (i) 1.0
- (ii) minus the credibility weight, as defined in section 2644.23(b),
- (B) multiplied by the complementary loss and defense cost containment expense, as defined in section 2644.23(d).

Stated as a formula:

$$\text{Credibility weight} \times (\text{loss} + \text{DCCE}) + (1 - \text{credibility weight}) \times \text{comp loss DCCE}$$

- (d) The complementary loss and defense and cost containment expense means
- (1) the quotient ~~product~~ of
- (A) the sum of
- (i) the trended current rate level premium, as defined in section 2644.24,
- (ii) multiplied by 1.0 plus the complement trend, as defined in section 2644.23(eg),
- (iii) multiplied by the maximum denominator, as defined in section 2644.2(c).
- (2B) ~~plus the sum of~~
- (i) the ancillary income, as defined in section 2644.13, ~~and~~
- (ii) divided by 1 minus the fixed investment income factor, as defined in section 2644.19.

Stated as a formula:

$$\text{Comp loss DCCE} = (\text{TCRLP} \times (1 + \text{comp trend}) \times \text{max denom} + \text{ancil income}) \div (1 - \text{fixed invest inc factor})$$

(e) Where the cost of reinsurance is allowed, as provided in section 2644.25, the credibility adjustment in subsection (c) shall be made to loss plus defense and cost containment expense minus reinsurance recoverable, as defined in section 2644.26.

(f) Where the cost of reinsurance is allowed, as provided in section 2644.25, the complementary loss and defense and cost containment expense means

- (1) The quotient of
- (A) The sum of
- (I) the trended current rate level premium, as defined in section 2644.24,
- (Ii) multiplied by 1.0 plus the complement trend, as defined in section 2644.23(g),
- (iii) Multiplied by the maximum denominator, as defined in section 2644.2(c).
- (B) plus the ancillary income, as defined in section 2644.13,
- (C) Minus the product of
- (I) the reinsurance premium, as used in section 2644.25, divided by 1 minus the variable expense factor, as defined in section 2644.14,
- (Ii) multiplied by the maximum denominator, as defined in section 2644.2(c),
- (2) Divided by 1 minus the fixed investment income factor, as defined in section 2644.19.

Stated as a formula:

$$\text{Comp loss DCCE} = (\text{TCRLP} \times (1 + \text{comp trend}) \times \text{max demon} + \text{ancil income} - \text{reins perm} / (1 - \text{vary exp factor}) \times \text{max demon}) / (1 - \text{fixed invest Inc factor})$$

(eg) The complement trend means the annual net trend plus one, raised to the power of the number of years from the effective date of the current rate to the proposed effective date of the proposed rates, minus one.

Stated as a formula:

$$\text{Comp trend} = ((\text{annual net trend} + 1) ^{\text{number of years}}) - 1$$

If the number of years from the effective date of the current rate to the proposed effective date of the proposed rates exceeds four, the complement trend shall be the annual net trend plus one, raised to the fourth power, minus one.

(fh) The annual net trend is the ratio of the loss trend, as defined in section 2644.7, annualized, plus one, divided by the premium trend, as defined in section 2644.7, annualized, plus one, minus one.

Stated as a formula:

$$\text{Annual net trend} = ((\text{annual loss trend} + 1) / (\text{annual premium trend} + 1)) - 1$$

(gi) If the credibility weight is less than 25% the applicant or the Commissioner may use an alternative complementary loss and defense and cost containment expense, provided that the alternative is the most actuarially sound method ~~and reasonable in the circumstance~~.

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.

§2644.25. Reinsurance.

(a) For all lines and sublines except for those listed in the next subparagraph, ratemaking shall be on a direct basis, with no consideration for the cost or benefits of reinsurance.

(b) For earthquake and for medical malpractice facultative reinsurance with attachment points above one million dollars, the maximum permitted earned premium is calculated as follows:

(1) The sum of
(A)(1) the quotient of
(A) the difference of
(i) the product of
(a) the projected losses, as defined in section 2644.4, (ii) plus the projected defense and cost containment expense, as defined in section 2644.8, (iii) minus the projected reinsurance recoverables, as defined in section 2644.26,

(b) multiplied by 1 minus the fixed investment income factor, as defined in section 2644.19(a),

(iv) ii minus the projected ancillary income, as defined in section 2644.13,
(v) ~~minus the fixed investment income, as defined in section 2644.19(a);~~
(B)-(B) divided by the sum of
(i) 1.0,
(ii) minus the efficiency standard, as defined in section 2644.12,
(iii) minus the maximum profit factor, as defined in section 2644.15,
(iv) plus the variable investment income factor, as defined in section 2644.19(b).

- (2) plus the quotient of
 (A) the reinsurance premium, net of ceding and contingent commissions,
 (B) divided by the difference of
 (i) 1.0,
 (ii) minus the variable expense factor, as defined in section 2644.14.

Stated as a formula:

$$\frac{\text{Max permitted EP} - \text{losses} + \text{DCCE} - \text{recoverables} - \text{ancil income} - \text{fixed invest inc} + \text{reins premium}}{1 - \text{eff std} - \text{profit factor} + \text{var invest inc factor} - \text{var exp factor}}$$

$$\text{Max permitted EP} = \frac{(\text{losses} + \text{DCCE} - \text{recoverables}) \times (1 - \text{fixed invest income factor}) - \text{ancil inc.} + \text{reins premium}}{1 - \text{eff std} - \text{profit factor} + \text{var invest inc factor} - \text{var exp factor}}$$

(c) For the calculation of fixed investment income factor, the numerator and denominator of the loss reserves ratio shall be adjusted for projected reinsurance recoverables, and for the variable investment income factor, the numerator and denominator of the unearned premium reserve ratio shall be adjusted to reflect the cash flows of the unearned reinsurance premium.

(d) Reinsurance costs shall ~~only~~ be allowed for ratemaking purposes as set forth in this section only if: (1) the reinsurance agreement was entered into in good faith in an arms-length transaction and at fair market value for the coverage provided, and (2) the reinsurance meets the statement credit requirements of Sections 2303 through 2303.25. Additionally, there must be an acceptable transfer of risk, and the reinsurance must comply with all applicable Statutory Accounting Principles.

(e) There will be no allowance for reinsurance between affiliated entities as set forth in Schedule Y of the Annual Statement.

~~(f) There will be no allowance for reinsurance through unauthorized reinsurers.~~

~~(g)~~ Copies of the reinsurance agreements shall be submitted with the filing.

~~(h)~~ For the purposes of this section and section 2644.26, reinsurance shall include other risk financing mechanisms, such as catastrophe bonds.

~~(i)~~ For the earthquake line, if at least 30% of the requested rate results from the cost of reinsurance, and a consumer or his or her representative requests a hearing within 45 days of public notice, the Commissioner shall hold a hearing on the issue of the reasonableness of the reinsurance costs, as defined in section (d), and whether some or all of those costs shall be reflected in the proposed rate change. An insurer's rate application shall indicate whether at least 30% of the requested rate results from the cost of reinsurance.

~~(j)~~ For the medical malpractice line, if at least 30% of the requested rate is attributable to the cost of facultative reinsurance with attachment points above one million dollars, and a consumer or his or her representative requests a hearing within 45 days of public notice, the Commissioner shall hold a hearing on the issue of the reasonableness of the reinsurance costs, as defined in section (d), and whether some or all of those costs shall be reflected in the proposed rate change. An insurer's rate application shall indicate whether at least 30% of the requested rate results from the cost of reinsurance.

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 ~~Form CA RA9~~ 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 ~~efficiency standard, rate of return, loss development factors or trend which will result if the variance is granted~~ 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 in the ~~applicable efficiency standard, rate of return, loss development factors or trend that is being proposed~~ 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:

(1) 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

(2) 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 will alter its mix of business in the rating period from the mix in the recorded period in a manner that affects the maximum and minimum permitted earned premium. Any such representation by the insurer shall specify the precise changes in business operations, shall be supported by a statement of an authorized official of the insurer indicating the manner in which the insurer plans to implement the change, and shall include such substantiating information as the Commissioner may require, including but not limited to specification of changes in the insurer's marketing program and relevant market research. Such representation shall be accompanied by the stipulation by the insurer to refund to consumers in a subsequent rate case if the change fails to materialize.~~

~~(2) That the insurer should be allowed to recover additional costs~~ relief from the efficiency standard for bona fide loss-prevention and loss-reduction activities, ~~provided the insurer can demonstrate loss reductions commensurate with the increased expenditures~~ 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 Total 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 adjustors 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 Cost 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.

(32) That the insurer should be allowed a ~~higher or lower~~ relief from the efficiency standard due to any or all of the following:

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

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

(C) ~~s~~Significantly smaller or larger than average California policy size 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.

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

(5) That the insurer should be authorized a rate of return leverage factor different from the rate of return leverage factor determined pursuant to section 2644.167 on the ground 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.

(64) 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.

(75) 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.

(86) 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.

(97) That the loss development formula in section 2644.6 does not produce an 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.

(108) That the trend formula in section 2644.7 does not produce ~~an~~ 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;
- (BC) There is a significant change in the law affecting the frequency or severity of claims;

(CD) It can be shown that a trends calculated over a period of at least a 10-year period 4 quarters other than a period permitted pursuant to section 2644.7(b) are is more reliable prospectively;

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

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

(119) 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. 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.

§ 2644.28. Prospective Application of Revisions to Regulations

Any amendment to this subchapter shall only apply prospectively. A rate change application shall be subject to the rules of this subchapter that are in effect on the date the application is received by the Commissioner pursuant to section 1861.05(c) of the Insurance Code.

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.