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

PROPOSED TEXT

DATE: May 16, 2008 **REGULATION FILE: REG-2008-0506-EFP**

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(~~g~~i). 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(~~g~~i). 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

(1~~8~~9) Burglary and theft

(~~19~~20) 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) ~~D~~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),

(~~3~~2) 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:

~~*Max Permitted EP = losses + DCCE – ancil income – fixed invest inc / max denom*~~

Max Permitted EP = (losses + DCCE) x (1-fixed invest inc factor) – ancil income / 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:

Max denom =1 – eff std - profit factor + 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~~, and~~
(B) multiplied by 1 minus the fixed investment income factor as defined in section 2644.19(a),
(~~3~~2) 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:

~~*Min Permitted EP = losses + DCCE – ancil income – fixed invest inc.*~~
~~*min denom*~~

Min Permitted EP = (losses + DCCE) x (1-fixed invest factor)-ancil income
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

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.

(~~a~~b) 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.

(~~b~~c) 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~~d) 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.

§2644.12. 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.

(~~d~~g) 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.

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

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

(1) The company is licensed in California;

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

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

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

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

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

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

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

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

(~~k~~n) Countrywide expenses for general and other acquisition expenses shall be allocated to California on the basis o~~n~~f direct earned premium. Countrywide expenses for adjusting and other expenses shall be allocated to California on the basis o~~n~~f 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:

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

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

(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:

$Var\ invest\ inc\ factor = yield \times \frac{FIT_{inv\ inc}}{FIT_{und}} \times$ *(uep reserves ratio ~~x~~ + 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: <u>average yield on Moody's A-rated public utility preferred stocks as provided by</u> 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:

Credibility weight x (loss + DCCE) + (1- credibility weight) x 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(~~e~~g),
(iii) multiplied by the maximum denominator, as defined in section 2644.2(c).
(~~2~~B) plus ~~the sum of~~
(i) the ancillary income, as defined in section 2644.13~~, and~~
(~~ii~~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 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)

(~~e~~g) 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.

(~~f~~h) 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) 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:

~~Max permitted EP = (losses + DCCE – recoverables – ancil income – fixed invest inc) / (1 – eff std – profit factor + var invest inc factor) + reins premium / (1- var exp factor)~~

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

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

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

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

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

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

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

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

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

(iii) Recoverable loss prevention expenses are those expended for employees whose duties are loss prevention, software dedicated to loss prevention, and equipment to be used for

loss prevention. Recoverable loss prevention expenses do not include the routine and customary costs of marketing or employing underwriters or adjusters.

(iv) The only loss prevention expenses recoverable are for loss prevention programs dedicated to loss prevention in the State of California or for the portion of the program within California. The burden of demonstrating the amount of loss prevention costs, and that those costs are expended for loss prevention in the State of California is on the insurer.

(~~3~~2) That the insurer should be allowed ~~a higher or lower~~ relief from the efficiency standard due to any or all of the following:

(A) H~~h~~igher ~~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.

(~~4~~3) ~~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 2644.1~~6~~7 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.

(~~6~~4) 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.

(~~7~~5) 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.

(~~8~~6) 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.

(~~9~~7) 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.

(~~10~~8) 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;

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

(~~C~~D) It can be shown that a trend~~s~~ 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;

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

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

(~~11~~9) 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.