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

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PROPOSED REGULATION TEXT[1]

~~§2642.4. Pure Premium.~~

~~"Pure premium" means the amount of losses per exposure, including allocated loss adjustment defense and cost containment expenses.~~

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

§2642.5. Rating Period.

"Rating period" means the period that must be accounted for in the application. ~~Unless otherwise determined pursuant to section 2646.3, t~~The rating period shall be one year commencing on the effective date of the rates. Nothing in this section shall be construed to specify the frequency of rate filings.

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

§2642.6. Recorded Period.

"Recorded period" means the historical period from which data are taken to provide the basis for the proposed rate. ~~Unless otherwise determined in accordance with section 2646.3, t~~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). 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). In no case shall the recorded period exceed ten 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; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *Calfarm Insurance Company v. Deukmejian* (1989) 48 Cal.3d 805.

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[1] Note: Language added to July 18, 2006, text is indicated in <u>double-underline</u>; language deleted from July 18, 2006, text is indicated in ~~double-strikeout~~.

§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 <u>liability</u>
(6) <u>Commercial multiple peril non-liability</u>
<u>(7)</u> Inland marine
(7<u>8</u>) Medical malpractice
(8<u>9</u>) Earthquake
(9<u>10</u>) Other liability
(1~~0~~<u>1</u>) Products liability
~~(10)~~ (1~~1~~<u>2</u>) Private passenger automobile liability
~~(11)~~ (1~~2~~<u>3</u>) Private passenger automobile physical damage
~~(12)~~ (1~~3~~<u>4</u>) Commercial automobile liability
~~(13)~~ (1~~4~~<u>5</u>) Commercial automobile physical damage
~~(14)~~ (1~~5~~<u>6</u>) Aircraft
~~(15)~~ (1~~6~~<u>7</u>) Fidelity
~~(16) Glass~~
(1~~7~~<u>8</u>) Burglary and theft
(1~~8~~<u>9</u>) Boiler and machinery.

<u>(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.</u>

(~~b~~<u>c</u>) Any insurer <u>or the Commissioner</u> 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." <u>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.</u>

(~~c~~<u>d</u>) 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) ~~professional liability or errors and omissions, except medical malpractice,~~
(~~G~~) directors' and officers' liability,
(~~H~~<u>G</u>) boiler and machinery insurance,

(~~I~~H) fidelity insurance,

(~~J~~I) mortgage guaranty insurance,

(~~K~~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,

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

(~~M~~L) Differences in conditions coverage.

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

~~§2643.2. Rating Basis.~~

~~Except as otherwise provided in this subchapter, rates are to be computed on the basis of premium charged per exposure. The Commissioner shall, from time to time, specify the appropriate exposure base or bases by line in accordance with section 2646.3. In lines where the Commissioner finds that rating on some other basis is more appropriate, the Commissioner shall authorize its use.~~

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

§2643.6. Interjurisdictional Allocations.

(a) Data shall be submitted with a rate application. Where reliable data exist for California losses, ~~allocated loss adjustment~~ defense and cost containment expenses, ancillary income, commissions, state premium taxes, loss reserves, and unearned premium reserves, those data shall be used. Where data are maintained on a multi-state basis only, or where California data are not reliable, the multi-state data shall be allocated to California as follows:

(1) ~~Allocated and unallocated loss adjustment~~ Defense and cost containment and adjusting and other expenses: By dollars of incurred losses.

(2) Commissions and brokerage: By earned premium.

(3) Taxes, licenses, and fees: By actual statutory tax rate for premium tax; by premium for licenses and fees.

(4) Other Acquisition: By number of written exposures or policies.

(5) General: By number of earned exposures or policies.

For purposes of this subsection, the determination whether data are "reliable" shall be made on the basis of whether the Commissioner finds, under the circumstances, that the data are authentic and believable. In making that finding, the Commissioner shall consider, among other things, whether the data were recorded by persons and under circumstances likely to produce accurate data, whether the data were relied upon by the party in its business, and whether the data are consistent with other data.

(b) Where an insurer submits recorded California data that varies from the California allocation of multi-state data allocated as specified in this section, the Commissioner shall require the insurer to demonstrate the accuracy of the data and to justify any deviation from the insurer's experience in other states. Where the Commissioner finds the demonstration or justification inadequate, he or she shall require the use of allocations rather than the submitted recorded data for California. Where the data are expressed as a percentage of earned premium, and are therefore mathematically related to the other components of premium, and the use of data other than the California allocation

of multi-state data is authorized, appropriate adjustments shall be made to any related data and to any applicable regulatory standards.

(c) Where an insurer or the Commissioner elects to disaggregate a line of insurance into commodity and specialty categories pursuant to section 2642.7, allocations between commodity and specialty shall be in the same proportion as specified in subdivision (a) of this section.

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

§2643.8. Factors Calculated by Commissioner.

Where regulations within Article 4 of ~~these regulations~~this title specif~~ies~~y that the Commissioner calculate and publish values for use in ~~numbers calculated and published by the Commissioner shall be used in~~ review of rate applications, the ~~numbers~~values used shall be the most recently published ~~numbers~~values, provided that the ~~numbers~~values were published at least 45 days before the receipt of the rate application by the Department's Rate Filing Bureau in San Francisco. Otherwise, the ~~numbers~~values used shall be those published immediately prior to publication of the most recent ~~numbers~~values.

If the Commissioner ~~fails to~~does not publish the ~~numbers~~values required by these regulations within the prescribed time period, the Rate Filing Bureau and, if applicable, the Administrative Hearing Bureau shall review the application by performing the calculations in the manner set forth in these regulations. Values used by the Rate Filing Bureau shall be updated by the Administrative Hearing Bureau before the close of the evidentiary hearing if one year or more has passed since the application was received~~application shall be reviewed performing the calculations in the manner set forth in these regulations and applied to the rate application~~.

NOTE: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *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) (1) projected losses, as defined in section 2644.4,
      (2) plus projected ~~allocated loss adjustment~~ defense and cost containment expenses, as defined in section 2644.8,
      ~~(3) plus projected fixed expenses, as defined in section 2644.9,~~
      (4~~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~~
         ~~(1) 1.0,~~
         ~~(2) minus the variable expense factor, as defined in section 2644.14,~~
         ~~(3) minus the maximum profit factor, as defined in section 2644.15,~~
         ~~(4) plus the investment income factor, as defined in section 2644.19.~~

      ~~Stated as a formula:~~

$$Max\ Permitted\ EP = \frac{losses + ALAE + fixed\ expenses - ancil\ income}{1 - var\ exp\ factor - profit\ factor + invest\ inc\ factor}$$

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

Stated as a formula:

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

(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; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *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) (1) projected losses, as defined in section 2644.4,
    (2) plus projected ~~allocated loss adjustment~~ defense and cost containment expenses, as defined in section 2644.8,
    ~~(3) plus projected fixed expenses, as defined in section 2644.9,~~
    (4~~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~~
    ~~(1) 1.0,~~
    ~~(2) minus the variable expense factor, as defined in section 2644.14,~~
    ~~(3) minus the minimum profit factor, as defined in section 2644.15,~~
    ~~(4) plus the investment income factor, as defined in section 2644.19.~~

~~Stated as a formula:~~

$$Min\ Permitted\ EP = \frac{losses + ALAE + fixed\ expenses - ancil\ income}{1 - var\ exp\ factor - profit\ factor + invest\ inc\ factor}$$

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

Stated as a formula:

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

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

§2644.4. Projected Losses.

(a) "Projected losses" means the insurer's historic losses per exposure, adjusted by catastrophe adjustment, as prescribed in section 2644.5, by loss development, as prescribed in section 2644.6, and by loss trend, as prescribed in section 2644.7.

(b) Projected losses shall be calculated by applying the loss trend factor separately to data from each accident-year in the recorded period. However, ~~for medical malpractice insurance, where the use of~~ for claims-made policies ~~predominates throughout the line~~, ~~projected losses are more appropriately evaluated on a report-year basis; accordingly, for medical malpractice insurance~~ projected losses shall be calculated on a report-year basis~~, except where occurrence policies predominate~~.

(c) For policies providing multi-year coverage, such as mechanical breakdown, projected losses may be calculated on a policy-year basis.

(d) ~~For policies providing death, disability and retirement coverage, the projected losses for this coverage shall be calculated using a sound actuarial method.~~

(ed) ~~Where an insurer or the Commissioner elects to disaggregate a line of insurance into commodity and specialty categories pursuant to section 2642.7~~For professional liability and errors and omissions coverage, the insurer shall, in lieu of the computation of projected losses specified in sections 2644.5 through 2644.7, tender an alternative computation of projected losses ~~for the specialty category~~, which the Commissioner shall approve if he or she finds the projection to have been made in ~~a~~the most sound actuarial manner. Nothing in this section precludes the Commissioner from requiring the additional filing of projected losses computed in the manner specified in sections 2644.5 through 2644.7.

(fe) For the earthquake line of business and for the fire following earthquake exposure in other lines, projected losses and defense and cost containment expenses may be based on complex catastrophe models using geological and structural engineering science and insurance claim expertise. The use of such models shall conform to the standards of practice as set forth by the Actuarial Standards Board and ~~that~~ the applicant shall have the burden of

proving, by a preponderance of the evidence, that the model is based upon the best available scientific information for assessing earthquake frequency, severity, damage and loss, and that the projected losses derived from the model meet all applicable statutory standards.

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

§2644.5. Catastrophe Adjustment.

In those insurance lines and coverages where catastrophes occur, the catastrophic losses of any one accident year in the recorded period are replaced by a loading based on a multi-year, long-term average of catastrophe claims. The Commissioner shall, from time to time, prescribe the number of years over which the average shall be calculated in accordance with section 2646.3 shall be at least 2~~1~~0 ~~and 39~~ years for homeowners multiple peril fire ~~and wind, respectively~~, and at least 10 years for private passenger auto physical damage. Where the insurer does not have enough years of data, the insurer's data shall be supplemented by appropriate data ~~from the most recent California advisory loss cost filing from the Insurance Services Office~~. The catastrophe adjustment shall reflect any changes between the insurer's historical and prospective exposure to catastrophe due to a change in the mix of business. There shall be no catastrophe adjustment for private passenger auto liability.

NOTE: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *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~~, for as many reporting intervals as the Commissioner may prescribe for a given line in accordance with section 2646.3~~. Filings shall contain both paid losses and case-specific reserves, stated separately. Loss development ~~may~~shall employ either paid losses or the sum of paid losses and case-specific reserves~~provided that if the ratio of case-specific reserves to paid losses increases by an amount greater than a figure to be specified by the Commissioner for the respective lines, in accordance with section 2646.3, loss development shall be based solely on paid losses~~. The insurer shall submit both the factors and ultimate losses for both paid and incurred loss development reported claims and the paid claims calculations, and shall demonstrate that its selection is the most actuarially reasonable. 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; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *Calfarm Insurance Company v. Deukmejian* (1989) 48 Cal.3d 805.

§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) ~~Loss trend factors shall be established in accordance with section 2646.3 for all insurers writing a given line.~~

(b) The Commissioner shall, from time to time, adopt trend factors for each line in accordance with section 2646.3. Trend factors shall be based on the exponential curve of best fit, as measured by the coefficient of determination , and as modified by the Commissioner to take into account factors not reflected in the historical data. Premium and Lloss trend Trend factors shall be developed using industry-wide the insurer's company-specific most recent twelve quarters of rolling calendar year data excluding catastrophes. paid pure premium loss, closed claim count and earned exposure data. 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 bases, and shall demonstrate that its selection is the most actuarially reasonable. Premium trend factors shall be developed using company-specific premium per exposure data. The insurer's most recent twelve quarters of rolling calendar year data excluding catastrophes shall be used.

(eb) Where the trend factor within a given line significantly varies by subline, by policy limits, by region of the state, or by coverage, the Commissioner shall, in accordance with section 2646.3, adopt separate trend factors shall be calculated in accordance with that evidence.

(dc) Changes in the law such as that created by Moradi-Shalal v. Fireman's Fund Ins. Companies (1988) 46 Cal.3d 287 can be expected to have a substantial effect on payouts, and consequently the Commissioner shall specify, in accordance with section 2646.3, the manner in which loss data predating Moradi-Shalal shall be adjusted in affected lines to take this change in the law into account. 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 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.

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

§2644.8. Projected Allocated Loss Adjustment Defense and Cost Containment Expenses.

(a) "Projected allocated loss adjustment defense and cost containment expenses" means the company's historic costs per exposure associated with the adjustment defense and cost containment of specific 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.

(bc) 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 allocated loss adjustment defense and cost containment expenses specified in this section, tender an alternative computation of

projected ~~allocated loss adjustment~~ <u>defense and cost containment</u> 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.

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

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~~§2644.9. Projected Fixed Expenses.~~

~~"Projected fixed expenses" means allowable historic fixed expenses per exposure, adjusted for expense trend, as prescribed in section 2644.11, subject to the efficiency standard specified in section 2644.12. "Fixed expenses" consist of the following:~~
~~(a) other acquisition, field supervision, and collection expenses incurred~~
~~(b) plus general expenses incurred~~
~~(c) plus state and local taxes, licenses, and fees incurred~~
~~(d) minus premium taxes~~
~~(e) plus unallocated loss adjustment expenses.~~
~~Commission and brokerage expenses shall not be included in fixed expenses.~~

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

§2644.10. Excluded Expenses.

The following expense items shall not be allowed for ratemaking purposes:

(a) Political contributions and lobbying.

(b) Executive compensation that exceeds the reasonable amount for such compensation~~, as the Commissioner shall from time to time determine in accordance with section 2646.3~~.
<u>For purposes of this computation, the following shall apply:</u>
<u>(1) "Executive" means the insurer's five highest-paid policymaking positions in each insurance group.</u>
<u>(2) "Compensation" means the total cash paid, including salary and bonus.</u>
<u>(3) "Maximum permissible executive compensation" means:</u>
<u>(A) For the highest paid executive in the group:</u>
<u>max comp = $1077(10^{1.4600 + 0.4060 \log X})$</u>
<u>(B) For the second-highest paid executive in the group:</u>
<u>max comp = $1077(10^{1.4140 + 0.3490 \log X})$</u>
<u>(C) For the third-highest paid executive in the group:</u>
<u>max comp = $1077(10^{1.2310 + 0.3820 \log X})$</u>
<u>(D) For the fourth-highest paid executive in the group:</u>
<u>max comp = $1077(10^{1.2470 + 0.3580 \log X})$</u>
<u>(E) For the fifth-highest paid executive in the group:</u>
<u>max comp = $1077(10^{1.2460 + 0.3420 \log X})$</u>
<u>where X is the greater of (i) the insurer's total countrywide direct earned premium for the most recent completed calendar year for lines of business subject to Proposition 103 divided by 1,000,000 or (ii) 70.</u>

(c) Bad faith judgments and associated ~~allocated loss adjustment~~ <u>defense and cost containment</u> expenses.

(d) All costs attendant to the unsuccessful defense of discrimination claims.

(e) Fines and penalties.

(f) Institutional advertising expenses. "Institutional advertising" means advertising not aimed at obtaining business for a specific insurer and not providing consumers with information pertinent to the decision whether to buy the insurer's product.

(g) All payments to affiliates, to the extent that such payments exceed the fair market rate or value of the goods or services in the open market.

Except as allocated pursuant to section 2643.6, calculation of the amounts expended on the foregoing expense items shall be based on the insurer's national expenditures, allocated among states in proportion to earned premium.

The disallowance shall be effected by reducing the efficiency standard by the ratio of the insurer's national excluded expenses to its national direct earned premium.

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

§2644.11. Expense Trend.

Allowable historic fixed expenses shall be adjusted for inflation. The Commissioner shall, from time to time, determine in accordance with section 2646.3 the expense trend factor by which allowable historic fixed expenses shall be multiplied. The expense trend factor may vary by insurance line. Unless the Commissioner finds some other method to be more appropriate, the expense trend factor shall be determined by taking the average year-to-year per-exposure fixed expense cost changes for the preceding three years.

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

§2644.12. Efficiency Standard.

(a) Notwithstanding any other provision of these regulations, projected fixed expenses shall not exceed
    (1) the product of
        (A) projected losses, as defined in section 2644.4,
        (B) plus projected allocated loss adjustment expenses, as defined in section 2644.8,
        (C) minus projected ancillary income, as defined in section 2644.13,
    (2) multiplied by
        (A) the efficiency standard, as specified in subdivision (b) of this section,
        (B) minus the variable expense factor, as defined in section 2644.14,
    (3) divided by

        (A) 1.0,
        (B) minus the maximum profit factor, as defined in section 2644.15,
        (C) plus the investment income factor, as defined in section 2644.19,
        (D) minus the efficiency standard, as specified in subdivision (b) of this section.

~~Stated as a formula:~~

$$\text{\textit{Max fixed exp}} = \frac{(\textit{losses} + \textit{DCCE} - \textit{ancil income})(\textit{effic std} - \textit{var exp factor})}{1 - \textit{profit factor} + \textit{invest inc factor} - \textit{effic std}}$$

(b<u>a</u>) The Commissioner shall~~, from time to time, adopt~~ <u>calculate</u> the efficiency standard ~~pursuant to section 2646.3~~ <u>annually, within 45 days of the publication of the necessary source data,</u> which shall be expressed as a maximum allowable ratio of historic underwriting expenses<u>, including adjusting and other expenses,</u> 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.

(e<u>b</u>) 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 ~~not functioning as agents~~ <u>selling insurance on a direct basis</u>. <u>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.</u> 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<u>, pursuant to section 2646.3</u>. 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<u>, pursuant to section 2646.3</u>, which shall apply to all insurers writing in that line regardless of distribution system. <u>For lines of business that combine personal and commercial exposures, the commissioner may set separate efficiency standards, pursuant to section 2646.3.</u>

(c) <u>The efficiency standard shall be calculated as the arithmetic average of the latest three years for which data are available.</u>

(d) In each category, the efficiency standard shall be set at the weighted mean (weighted by earned premium<u> in California</u>) expense ratio of insurers in that category. In calculating the average, the Commissioner may exclude insurers for which reliable data are not readily available ~~or which reflect anomalous conditions~~.

(e) <u>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.</u>

(f) <u>A company's data shall be included in the calculation only if</u>
    <u>(1) The company is licensed in California;</u>
    <u>(2) The company's California direct earned premium is greater than zero;</u>
    <u>(3) The company's countrywide direct earned premium is greater than zero;</u>
    <u>(4) The company's countrywide direct losses incurred is greater than zero; and</u>
    <u>(5) The company's ratio of underwriting expenses, including adjusting and other expenses, to earned premium is greater than zero and less than 65%.</u>

(g) <u>If a company's commission expense is less than zero, the negative amount shall be set to zero.</u>

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

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

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

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

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

§2644.15. Profit Factors.

 (a) The "maximum profit factor" means
        (1) The maximum permitted after-tax rate of return, as defined in section 2644.16,
        (2) divided by the product of
            (A) the leverage factor, as defined in section 2644.17,
            (B) multiplied by the underwriting federal income tax factor, as defined in section 2644.18.

 (b) The "minimum profit factor" means
        (1) the minimum permitted after-tax rate of return, as defined in section 2644.16,
        (2) divided by the product of
            (A) the leverage factor, as defined in section 2644.17,
            (B) multiplied by the underwriting federal income tax factor, as defined in section 2644.18.

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

§2644.16. Rate of Return.

(a) The maximum permitted after-tax rate of return ~shall be 11%~ means the risk-free rate, as defined in section 2644.20(d), plus 6%.

(b) ~The Commissioner shall, from time to time, determine, in accordance with section 2646.3, the~ maximum and ~minimum permitted after-tax rate of return for property and casualty insurance ratemaking. The maximum and minimum profit factors~ shall ~represent~ the ~range of yields on investments in other enterprises presenting risks to investors comparable to~ giving due consideration to the competing interests of investors and consumers, and taking into account the fact that insurance is imbued with the public interest and that its purchase is sometimes legally required.

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.

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

§2644.17. Leverage Factor and Surplus.

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

(b) The Commissioner shall~~, from time to time, establish, in accordance with section 2646.3,~~ 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. ~~Each insurer's~~ Total national industry surplus shall be allocated to ~~its respective~~ lines of business in proportion to the national industry-wide unearned premium, loss and loss adjustment expense reserves. ~~In determining the leverage ratios, the Commissioner shall give due consideration to regulatory standards of solvency and actual industry-wide, all-lines ratio of net written premiums to surplus.~~ The leverage factor for each line of business shall be the national premium divided by the allocated surplus~~, then multiplied by the ratio of the 30-year historical average total industry leverage divided by the total industry leverage in the most recent year.~~

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. ~~In lines perceived to have higher risk, the Commissioner may establish, in accordance with section 2646.3, higher surplus requirements, and insurers may earn the rate of return on the higher surplus.~~ 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; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *Calfarm Insurance Company v. Deukmejian* (1989) 48 Cal.3d 805.

§2644.18. Federal Income Tax Factors.

~~(a) "Federal income tax factor" means 1.0 minus the insurer's effective federal income tax rate reported in the most recent year for which historical data are available, giving full account to all tax credits and offsets used or available to the insurer. Where there has been a change in tax laws between the recorded period and the rating period, the effective tax rate shall be calculated using the historical data and the tax rules for the rating period.~~
~~(b) Where the insurer had a net tax credit, or where the insurer had a net tax liability on a net pretax loss, the effective tax rate shall be zero and~~
~~(1) if the insurer had a net tax credit, the amount of the credit shall be added, as a positive number, to nationwide projected ancillary income;~~
~~(2) if the insurer had a net tax liability, the amount of the liability shall be subtracted from nationwide projected ancillary income.~~
~~(c) Where the insurer's effective tax rate reported in the most recent year for which historical data are available exceeded 34% and the insurer had a net tax liability on a net pretax profit, the effective tax rate shall be 34% and the amount by which the tax liability exceeded 34% shall be subtracted from nationwide ancillary income.~~

(a) "Underwriting federal income tax factor" means 1.0 minus the prospective federal income tax rate on underwriting. The Commissioner finds that the prospective federal income tax rate on underwriting is 35%.

(b) "Investment federal income tax factor" means 1.0 minus the prospective federal income tax rate on investment income. The prospective federal income tax rate on investment income shall be calculated using the weighted yield, adjusted for investment expenses, computed in section 2644.20 and shall take into account any tax preferences and exemptions for the income from each asset class and from each category of bond issuer. The Commissioner finds that the prospective federal income tax rate on the investment income from taxable bonds, mortgage loans, real estate, cash and short-term investments and on investment expenses is 35%, on capital gains is 34.1%, on tax-exempt bond interest is 5.25% and on stock dividends is 14.175%. For investment income on other invested assets, the prospective federal income tax rate shall be the weighted average of the tax rates on the above categories.

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

§2644.19. Investment Income Factors.

~~"Investment income factor" means the projected yield, as defined in section 2644.20, multiplied by the sum of~~
~~(a) the reserves ratio, as defined in section 2644.21,~~
~~(b) plus the surplus ratio, as defined in section 2644.22~~

 (a) "Fixed investment income" 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:

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

(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:

$$Var\ invest\ inc\ factor = yield \times \frac{FIT_{inv\,inc}}{FIT_{und}} \times (uep\ reserves\ ratio + surplus\ ratio)$$

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

§2644.20. Projected Yield.

"Projected yield" means the insurer's imbedded yield in the most recent year for which investment results have been reported, plus an average of the insurer's realized capital gains over the most recent five years. Imbedded yield shall be calculated as the insurer's net investment income, excluding capital gains, divided by the average of the insurer's start-of-year and year-end surplus and reserves for the most recent year for which investment results have been reported.

(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/ValuBond
        (C) Long: average yield on 20-year corporate A and AA rated bonds as provided by Valu/Bond on Yahoo.com/ValuBond
(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/ValuBond
        (C) Long: average yield on 20-year municipal A and AA rated bonds as provided by Valu/Bond on Yahoo.com/ValuBond
(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: 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 ~~medium~~ 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; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *Calfarm Insurance Company v. Deukmejian* (1989) 48 Cal.3d 805.

§2644.21. Reserves Ratio.

~~"Reserves ratio" means~~
~~(a) the average of the last two years'~~
~~(1) loss reserves plus~~
~~(2) loss adjustment expense reserves, plus~~
~~(3) unearned premium reserves~~
~~(b) divided by the earned premium for the most recent year for which data are available.~~

(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.

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; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *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~~, as appropriate, to projected losses, projected allocated loss adjustment expenses, projected loss development, and projected allocated loss adjustment expenses development~~.

(b) ~~The Commissioner shall, from time to time, specify credibility criteria and appropriate sources of substitute data in accordance with section 2646.3.~~ For each form for homeowners multiple peril and for each coverage for private passenger auto liability and physical damage the standard for full credibility ~~standard~~ 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.

~~(c) The credibility adjustment shall consist of adding to the insurer's data sufficient additional data, drawn from an approved source of substitute data, approved in accordance with section 2646.3, to provide a total sample size sufficient to meet the applicable credibility criterion established by the Commissioner.~~

(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:

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

(d) The complementary loss and defense and cost containment expense means
> (1) the product 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),
> > (iii) multiplied by the maximum denominator, as defined in section 2644.2(~~b~~c).
> (2) plus the sum of
> > (i) the ancillary income, as defined in section 2644.3, and
> > (ii) the fixed investment income, as defined in section 2644.19.

Stated as a formula:

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

(e) 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) ~~The annual net trend is the annual loss trend plus one, divided by the annual premium trend plus one, minus one.~~ 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 setion 2644.7, annualized, plus one, minus one.

Stated as a formula:

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

(g) 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 actuarially sound and reasonable in the circumstance.

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

§2644.24. Trended Current Rate Level Earned Premium.

"Trended current rate level earned premium" means the earned premium per exposure for the recorded period adjusted to the current rate level based on subsequent rate changes and further adjusted for premium trend. The trend adjustment shall be calculated by applying the premium trend factor separately to data from each year in the recorded period.

NOTE: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *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) the quotient of
      (i) 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,
      (iv) 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:

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

(c) For the calculation of fixed investment income, 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 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 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; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *Calfarm Insurance Company v. Deukmejian* (1989) 48 Cal.3d 805.

§2644.26. Reinsurance Recoverables.

"Reinsurance recoverables" means all amounts recoverable from reinsurers for paid and unpaid losses and loss adjustment expenses per exposure, including estimated amounts receivable for unsettled claims and claims incurred but not reported as provided under reinsurance agreements.

NOTE: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; *20th Century v. Garamendi*, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; *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. 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;
        (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, or rate of return, loss development factors or trend that is being proposed.

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

(d) A variance request shall be deemed approved sixty days after public notice unless:
        (i)   a consumer or his or her representative requests a hearing within forty-five days of public notice and the Commissioner grants the hearing, or determines not to grant the hearing and issues written findings in support of that decision, or
        (ii)   the Commissioner on his or her own motion determines to hold a hearing.

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

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

(1) That the insurer 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 for bona fide loss-prevention and loss-reduction activities, provided the insurer can demonstrate loss reductions commensurate with the increased expenditures.

(3) That the insurer should be allowed a higher or lower efficiency standard due to:
(A) higher or lower quality of service, as demonstrated by objective measures of consumer satisfaction; or
(B) demonstrably superior or inferior service to underserved communities, as defined in section 2646.6; or
(C) significantly smaller or larger than average policy size.

(4) 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 different from the rate of return determined pursuant to section 2644.16 on the ground that the insurer writes at least 90% of its direct premium in one line or in California and its mix of business presents investment risks different from the risks that are typical of the line as a whole.

(6) 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) 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) 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) 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 ~~settling~~ 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.

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

(C) It can be shown that trends calculated over at least a 10-year period are more reliable prospectively;

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

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

(11) 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.

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

ARTICLE 4.5 REFILING OF APPROVED RATES

§2644.50. Refiling of Approved Rates

As a means to determine whether a rate previously approved remains in compliance with the statutory standard set forth in California Insurance Code Section 1861.05(a), for an insurer operating with a rate approved three years ago or longer in the homeowners multiple peril and private passenger auto liability and physical damage lines, the Commissioner may require an insurer to file a rate application.

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

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

§ 2646.3. Generic Determinations

(a) "Generic determination" means a finding the Commissioner is required or authorized by these regulations to make, which finding is intended to apply to the rate applications of several or all insurers.

(b) ~~Where these regulations provide for the Commissioner to make a generic determination, the determination shall be made in a consolidated hearing upon not less than 30 days' written notice by first-class mail to all affected insurers and any other interested persons known to the department. All affected insurers and any other interested persons shall be entitled to become parties upon written request no less than 14 days after service of notice.~~ The generic determination shall be adopted as a regulation pursuant to

chapter 3.5 (<u>sections 11340 through 11356 of the Government Code</u>), upon final decision of the Commissioner, and shall be binding in hearings on individual insurers' rates.

(c) In a hearing convened for the purpose of making a generic determination, any person may propose that the pertinent data be disaggregated by geographic region, policy limits and deductibles, or amount of premium the insurer writes in the line and that separate determinations be ma~~k~~<u>d</u>e for each category. This subsection does not authorize insurer-by-insurer generic determinations.

(d) The Commissioner may, from time to time, review generic determinations to assess whether they are still sound. Such review may be on the Commissioner's own motion or on the petition of any person. Any such petition shall specify the changes in circumstances giving rise to the need for a revised determination.

~~(e) The Commissioner shall grant or deny the written petition in a written order. An order granting the petition shall call a hearing, and shall give notice pursuant to subdivision (b) of this section, to consider a revised generic determination. An order denying the petition shall specify the grounds for denial, which shall be either:~~

~~(1) that the petition has failed to raise any change in circumstances and merely alleges matters already considered, or~~

~~(2) that the changes in circumstance alleged do not warrant any change in the generic determination.~~

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

§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~~,~~ <u>and</u> these regulations~~, and the generic determinations made pursuant to 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~~,~~ <u>and</u> these regulations, ~~and the generic determinations made pursuant to these regulations~~ should be adjusted as provided in ~~subdivision (c) of this~~ section <u>2644.27</u>. A request that the maximum permitted earned premium or minimum permitted earned premium should be adjusted is referred to as a "variance request."

~~(c) 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 for bona fide loss prevention and loss-reduction activities, provided the insurer can demonstrate loss reductions commensurate with the increased expenditures.
(3) That the insurer should be allowed a higher or lower return on equity due to:
(A) higher or lower quality of service, as demonstrated by objective measures of consumer satisfaction; or
(B) demonstrably superior or inferior service to markets historically inadequately served by the insurance industry.
(4) That the insurer should be authorized a rate of return different from the rate of return determined pursuant to section 2644.16 on the ground that the insurer writes in only one line and its mix of business presents investment risks different from the risks that are typical of the line as a whole.
(5) That the insurer should be granted relief from operation of the efficiency standard for a line of insurance in which the insurer has never previously written over $1 million in earned premiums annually and in which the insurer has made or is making a substantial investment in order to enter the market. Any such request shall be accompanied by a proposed amortization schedule to distribute the start-up investment.
(6) That the insurer should be permitted to employ a loss trend other than the trend adopted pursuant to section 2644.7 because
(A) the trend in the insurer's own losses has exceeded the trend adopted pursuant to section 2644.7 in each of the three preceding years by at least five percent of the trend factor, or
(B) the trend in the insurer's own losses has been less than the trend adopted pursuant to section 2644.7 in each of the three preceding years by at least five percent of the trend factor.
"Trend factor" means one plus the annual trend expressed as a percentage.
(7) 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) 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.

(d) In a hearing on an insurer's rollback obligation, the grounds for variance specified in subdivisions (c)(4), (c)(5), and (c)(8) of this section shall be valid bases for requesting a variance. For purposes of a hearing on an insurer's rollback obligation, a request for a variance based on subdivision (c)(8) of this section shall be a request for a variance from the minimum permitted earned premium. The provisions of subdivisions (c)(1), (c)(2), (c)(3), (c)(6), and (c)(7) are inapplicable to hearings on rollbacks.

(ec) 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.

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

§ 2648.4. Complete Application.

_____ (c) Requests for variances as authorized by section 2644.27 shall be on the following form:

STATE OF CALIFORNIA   Insurer Name
DEPARTMENT OF INSURANCE   Line of Business

Request for Variance

1.   Identify each variance requested.

2.   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.

3.   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.

4.   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, or rate of return, loss development factors or trend that is being proposed.

xx-xx-06 ed.   CA-RA9

NOTE: Authority cited: Sections 1861.01 and 1861.055, Insurance Code. Reference: Sections 1861.05, 1861.07 and 1861.055, Insurance Code.