NOTES ON CDI'S WORKSHOP ON SUGGESTED REVISIONS TO PRIOR APPROVAL REGULATIONS

Tuesday, December 16, 2008 at 10:27AM

Prior Approval Workshop (Dec. 12, 2008)

On Friday, December 12, 2008, the California Department of Insurance ("CDI") held its pre-notice public discussions on contemplated revisions to the prior approval rate regulations. The CDI panel that presided over the discussions consisted of Adam Cole (General Counsel), William Gausewitz (Special Counsel to the Commissioner), Jesse Huff (Special Assistant to the Commissioner), and Bryant Henley (Senior Staff Counsel).

At the outset, Gausewitz made clear that the contemplated revisions to the prior approval regulations were not being formally proposed and that this workshop was just an opportunity to get preliminary thoughts from interested parties. Gausewitz also noted that there was no formal agenda. He noted that there were a number of individuals who identified themselves as those wished to speak, but he reminded that anyone who had a comment was encouraged to speak.

The first person invited to speak was Harvey Rosenfield of Consumer Watchdog. Rosenfield initially gave an overview of his view of why Proposition 103 was approved by the California electorate and noted that Proposition 103 resulted in the savings of hundreds of millions of dollars for California consumers, particularly through the prior approval regulations in effect prior to 2007 (which Rosenfield referred to as the "Garamendi" regulations).

Rosenfield noted that the newly contemplated revisions to the prior approval regulations undermined the "Garamendi" regulations in that it would allow insurers to "game the system" and obtain excessive profits. Rosenfield also described the newly suggested revisions to be illegal, "poorly vetted," "poorly crafted," and "half-baked" and noted that none were pro-consumer. He believed that these newly revised regulations constituted a "wholesale deregulation" of the industry.

Cole asked Rosenfield to specifically identify what provisions he considered illegal and why. In response, Rosenfield identified those regulations that permitted the "phasing" in of rate changes that are greater than 15% (i.e., proposed Section 2644.29) and the expedited review and approval of rate reductions (i.e., proposed Section 2644.51). In explaining why he believed these suggested provisions to be illegal, Rosenfield noted that under each of these suggested regulations, it is contemplated that an insurer may charge a rate that is unlawful (i.e., that is excessive, inadequate or unfairly discriminatory).

Gausewitz noted that, at least with respect to the expedited rate reduction process, that this provision was pro-consumer as it allowed insurers a way to expeditiously role out decreased rates to the general public. Gausewitz also noted that no provision had been suggested for an expedited rate increase process. In response, Rosenfield noted that this provision was nevertheless unlawful as it did not comport with Proposition 103.

Gausewitz invited others to make any general comments on the suggested revisions to the prior approval regulations, but no one volunteered to make any such comments. He then noted that it was his view that there seemed to be four issues raised by the suggested revisions – that is, the suggested revisions concerning (1) the efficiency standard, (2) the expedited rate reduction, (3) the incremental implementation of large rate changes, and (4) the rate of return. He invited people to speak on each subject in turn.

Notes of those comments are as follows:

Efficiency Standard

With respect to the efficiency standard, the CDI proposes creating an efficiency standard range between a "maximum and a minimum allowable ratio of historic underwriting expenses, including adjusting and other expenses to historic earned premiums, which represents the fixed and variable cost for a reasonably efficient insurer to provide insurance and to render good service to its customers."

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

Shawna Ackerman of Pinnacle Actuarial Resources, Inc., who spoke on behalf of PIF and ACIC, was the first to comment on these suggested revisions. While she initially noted that she would always recommend using the individual insurer's costs, she recognized that there is counter-balancing need on the part of the CDI to be able to effectively deal with this issue on an industry wide basis. From that perspective, Ackerman noted that the suggested revisions to the efficiency standard were generally fine, but required clarification. For instance, she noted that there needed to be a clarification of "standard of deviation." Also, because rate-making is an exercise in predicting future rates, she noted that the regulations should permit the use of a company's "projected" expenses and not "actual" expenses.

Gausewitz noted that the goals sought to be achieved by this contemplated change was to still allow insurers to reap the benefits of being efficient (but to limit the amount of that benefit) and expand an insurer's ability to capture its actual expenses that might not otherwise be captured under the current system (but to still have a cap on what may be captured). Gausewitz and Huff appeared to acknowledge that historic data may not be 100% accurate in predicting future costs, but suggested that concerns over the use of "actual" expenses (as opposed to "projected" expenses) – in that "actual" expenses" may not accurately predict future costs in certain circumstances – could be dealt with by way of currently existing variances.

Diana Estrada (Fireman's Fund) also spoke and said that she support the change to the efficiency standard calculation and believe it is a step in the right direction to enable companies to obtain correct rates.

Alice Bison (Auto Club) noted that she was uncomfortable with the change as it would result in a loss by efficient companies and would take away an incentive on the part of companies to be efficient.

Expedited Process for Approving Rate Decreases

The next potential amendment discussed at the workshop was the addition of an expedited process for the approval of a rate decrease. Under this suggested amendment, "an insurer desiring to reduce an approved rate may do so by filing an Application to Reduce Rates, on a form established by the Commissioner. The Application to Reduce Rates shall include all the information required for a complete rate application by section 1861.05 of the Insurance Code. An Application to Reduce Rates shall be deemed approved, as submitted, 60 days after the complete application is received by the Commissioner unless the Commissioner within those 60 days orders a hearing on the application pursuant to section 1861.05 of the Insurance Code."

Pursuant to the suggested amendment, "[a] rate reduction pursuant to this section may be made only on the basis of the insurer's certification, and the Commissioner's finding, that the rate will not cause the insurer's financial condition to present an undue risk to its solvency and will not otherwise be in violation of the law."

Ackerman noted that she was generally in favor of this suggested amendment, but felt that there were a number of clarifications that could be made.

First, Ackerman noted that the 60 day period could be calculated from the date of public notice. Under the suggested amendment, this period started "after the complete application is received by the Commissioner," which provided a less clearly delineated date from which the period would start.

Second, Ackerman believed that there should be some guidelines on what constitutes a "complete application" to assist companies in ensuring that they correctly provide all information that needs to be provided so that they could correctly comply with this regulation.

Third, Ackerman noted that the CDI may want to contemplate allowing for the expedited approval of rate decrease <u>and class plan</u>, particularly where a class plan is revenue neutral.

Fourth, Ackerman noted that the CDI may want to contemplate the addition or clarification allowing for the expedited approval of "forms" when then are effectively rate decreases.

Fifth, Ackerman noted the language requiring an <u>affirmative</u> finding by the Commissioner that the rate decrease should not pose an insolvency risk should be altered to permit approval of a rate decrease <u>unless</u> there is a finding of insolvency risk. The reason for this suggested change is to further the goal of getting lower rates out to consumer on a more expedited basis.

Sixth, Ackerman noted a provision should be in place making clear that a company should not be required to provide a refund of premiums if there is a subsequent review and determination that an insurer's rate is excessive.

In response to these comments, the panel did not have any particular comments or criticisms, but did have exploratory questions. Gausewitz also noted that Ackerman's comments would appear to indicate that she appeared to suggest that contemplated regulations would appear to provide for a "less thorough" review of a rate decrease application. Ackerman agreed that this was her understanding of the import of that provision.

Kai Fung (CSE Insurance) noted that there should be a process in place to allow for an expedited approval of a rate increase for companies that are under financial distress. The panel noted that such a provision would be problematic given the fact that the general public needs to be given adequate time to allow for consumer participation.

<u>Rate of Return</u>

In the May 2008 version of the prior approval regulations, the CDI had added section 2644.16(c), which provided that "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." In the suggested revisions, the CDI proposes to remove this provision as unworkable because of the use of the term "cost of capital."

Ackerman noted that an actuary from a company that was a member of PIF came up with a proposed solution to dealing with a rate of return determination. Specifically, the proposal is to use the rate of return information from the 50 largest publicly trade property and casualty companies for the last 15 years to develop an appropriate rate of return. A rate of return could be expressed in terms of a standard of deviation from the result of the survey. Ackerman noted that she would submit a specific document detailing the methodology for employing this approach with the CDI.

While it was acknowledged that this survey would only include publicly traded companies, it was only these companies who would have public filings from which rate of return data could be gathered. Further, it was also suggested that this might be a good proxy given the market share of premiums sold by publicly traded companies.

Under this newly proposed calculation, and if one standard of deviation was employed, Ackerman noted that a rate of return calculation would come out to approximately 15%, which Cole seemed to suggest was high. It was observed that the CDI could use a fraction of a standard of deviation and that while the numbers initially suggested could be modified, the overall approach would be a good way to get to the right number. It was also observed by a member of the gallery that 15% would fall right around the rate of return of 14.5%, which was used under the pre-2007 prior approval regulations under the "Garamendi" regulations.

Other Issues

No one had specific comments on the "enterprise as a whole" regulation. Further, there were additional comments on other proposed changes to the regulations that were not specifically raised by the CDI's suggested revisions to the prior approval regulations and, therefore, were not prepared to be addressed by the panel. Finally, the Consumer Watchdog was asked if it was their intent to provide any more specific comments on the newly contemplated regulations, but it was indicated that they would not likely have any such comments at this time.

The panel noted that if anyone wanted to submit additional information on any items discussed they were encouraged to do so. While the panel could not give a firm deadline at to when they would move forward with a more formal pronouncement of revisions to the regulations, Gausewitz noted that they would not take any action before the end of the year. Therefore, he suggested that any submissions be provided before December 31, 2008.