

**THE NEW STANDARD FOR REVIEW  
OF RATE APPLICATIONS IN CALIFORNIA**

By

ROBERT W. HOGEBOOM\*  
213.680.2800

**1. Introduction**

This article reviews recent developments affecting property and casualty insurance rate applications in California. On August 22, 2003, California Insurance Commissioner John Garamendi adopted the proposed decision of Administrative Law Judge Marjorie A. Rasmussen regarding the rate increase application of SCPIE Indemnity Company and American Health Care Indemnity Company (collectively, "SCPIE").<sup>1</sup> The SCPIE decision is important because it establishes the methodology under which California rate applications will be tested in the future.

In his order adopting Judge Rasmussen's decision, Commissioner Garamendi stated that the standard of review expressed in that decision would serve as precedent for future proceedings. Under the SCPIE decision, the Commissioner will strictly apply the ratemaking formula set forth in the existing regulations,<sup>2</sup> using actuarial principles to develop the values for the rating elements that depend on generic determinations that the Commissioner has not adopted. This article examines the background of the court's decision and explains the methodology adopted by the Commissioner to test rate applications both within and outside the hearing process.

**2. The Prior Approval Regulations**

Before the adoption of Proposition 103 on November 8, 1988, California was an open competition state, meaning that insurers could freely charge any rate without the prior approval of the Department of Insurance ("Department"), subject to the general standard that rates may not be "excessive, inadequate or unfairly discriminatory." Proposition 103 established that property and casualty rates are subject to the Department's prior approval, mandated a 20 percent rate rollback and established the Commissioner of Insurance as an elected official.<sup>3</sup>

In 1991, shortly after taking office as the first elected Insurance Commissioner, John Garamendi commenced a hearing to determine the basis for implementing the initiative's rate rollback and prior approval provisions, and thereafter issued regulations governing the methodology for determining rate rollbacks. The central element of the regulations was a mathematical ratemaking formula intended to determine whether rates charged on or after the effective date of Proposition 103 were excessive. The ratemaking formula was designed to yield a premium allowing the insurer to earn a sum amounting to (1) the reasonable cost of providing insurance and (2) the capital used and useful for providing insurance multiplied by a fair rate of return.<sup>4</sup> This formula with various modifications is the same formula that exists in the regulations today and which Judge Rasmussen applied in the *SCPIE* case. The formula consists of a number of elements or components, and the regulations set forth their definitions. Some of these definitions consist of subformulas, and others require the Commissioner to establish generic values using industry data.

As the California Supreme Court explained in the *20<sup>th</sup> Century* case, the formula contains two types of components: "(1) regulations strictly so-called, *viz.*, rules generally applicable to all insurers formulated in quasi-legislative proceedings; and (2) regulations incorporating generic determinations, *viz.*, findings related to all or at least several insurers made in consolidated hearings conducted in accordance with quasi-adjudicatory procedures and then adopted as regulations."<sup>5</sup> In *20<sup>th</sup> Century*, the Supreme Court held that the regulations and determinations were valid both generally and specifically as used to implement the rate rollbacks.<sup>6</sup>

After promulgating the regulations, Commissioner Garamendi's first task was to apply the formula to implement Proposition 103's rate rollback. To do this, he held extensive generic determination hearings considering historical data from California insurers and adopted the factors that would be used in calculating the rollback amounts.

Commissioner Garamendi never applied the generic determinations to prior approval rate applications, as no generic determinations had been adopted for that purpose. Rather, prior approval rate applications were reviewed by staff and in rate hearings using standard actuarial principles applied to the evidence presented.

When Commissioner Chuck Quackenbush took office in January 1995, his first priority was to resolve the outstanding rollback obligations. To do so, he attempted to streamline the rollback hearings to eliminate the backlog of outstanding cases. On August 18, 1995, Commissioner Quackenbush adopted emergency regulations (CDI File No. RH-339), establishing procedures for rate hearings and adopting the basic formula promulgated by Commissioner Garamendi in his expired regulations. On February 1, 1996, the regulations were approved as permanent, at Title 10, California Code of Regulations, sections 2641.1 *et seq.*, and remain in effect today.

While the ratemaking formula was intended to govern and help resolve the outstanding rate rollbacks, by their terms they also applied to prior approval rate applications. Commissioner Quackenbush used Commissioner Garamendi's generic factors for rate rollbacks but did not adopt generic determinations applicable to prior approval. To date, the generic determinations have not been adopted.

### **3. History of Prior Approval Rate Hearings**

While the effort to adopt generic factors continued without result, the Department routinely reviewed and approved insurers' rate applications. With regard to the Department's internal procedures, it evaluated rate change applications on a case-by-case basis. In reviewing applications the Department has utilized a computerized template consisting of the formula – including values for the generic factors – to allow the template to produce a maximum permitted earned premium. The generic values are adjusted periodically and modified depending on the circumstances. The Department uses the template as a guide, not to make a final determination on a particular rate application. We understand that the Department has not treated the results of the template as determinative, but that applications are approved or rejected based on the judgment of the Department analyst and actuarial staff who determine whether the data, methods and assumptions are reasonable and appropriate under the circumstances.

Consistent with the Department's methodology before the *SCPIE* Decision, contested rate applications were also reviewed using standard actuarial principles without reliance on the formula. In *Dawson v. California Department of Insurance*, Case No. A086143 (Sept. 14, 2000), the court observed that because the generic determinations had not been adopted, the "Department does not (nor can it) use the ratemaking formula contained in the Proposition 103 regulations to evaluate rate change applications that are submitted to it for prior approval."<sup>7</sup> Accordingly, administrative courts originally based their decisions on the reasonableness of the insurer's rate calculation based on standard actuarial principles applied to the evidence presented.

### **4. The Rate Formula**

The regulations contain a computational formula to determine whether a proposed rate is excessive or inadequate. With inputs of the insurer's data and the generic components, the formula calculates a maximum and a minimum permitted earned premium for a line of insurance. The formula for the maximum permitted premium, contained at regulation section 2644.2, is:

$$\text{Max. Permitted} = \frac{\text{Losses} + \text{ALAE} + \text{Fixed Expenses} - \text{Ancillary Income}}{\text{1-Variable Expense Factor} - \text{Profit Factor} + \text{Investment Income Factor}}$$

**Earned Premium**

The ratemaking formula is prospective, as it reflects calculation of a rate that will go into effect in the future. Thus, while much of the data that goes into the formula is historical, the formula necessitates that the insurer apply trend factors to that data to forecast the rate need for the period during which the rate will be in effect (the "rate period"). Trending is applied, for example, to historical losses and allocated loss adjustment expenses ("ALAE") to anticipate the losses and expenses that the insurer will incur for the period during the rate period.

### **B. Rate Regulations**

The regulations, at sections 2644.4 through 2644.23, determine how each component of the rate formula is calculated. Several regulations may apply to each component, and many components consist, in turn, of subformulas. The essential components of the formula include:

- (i) Projected Losses
- (ii) Projected ALAE
- (iii) Projected Fixed Expenses
- (iv) Projected Ancillary Income
- (v) Variable Expense Factor
- (vi) Profit Factor
- (vii) Investment Income
- (viii) Rating Basis
- (ix) Catastrophe Adjustment
- (x) Loss Trend and ALAE Trend
- (xi) Expense Trend
- (xii) Efficiency Standard
- (xiii) Rate of Return
- (xiv) Leverage Factors
- (xv) Credibility Adjustment

## 5. How Rate Applications Are Prepared

The ratemaking process involves an analysis of historical data and other relevant information to estimate the future costs for a particular line of insurance. The customary approach to ratemaking for insurers that have written a substantial amount of business for a significant period of time is to analyze their own historical losses, premiums and expenses for that line.

Most actuaries use the loss ratio method in ratemaking. This method estimates the change required to the current premium in order to arrive at a prospective premium that will cover the costs of the policies issued during the rating period plus a reasonable profit. Under this process the actuary calculates the indicated change to the current rate, and that change is multiplied by the current rate structure to arrive at the prospective average premium.

Pursuant to Insurance Code section 1861.05, an insurer desiring to change its rates must complete a rate application and file it with the Commissioner. The rate application forms are codified at section 2648.4 of the Regulations. The ratemaking process is outlined on the form designated "CA-RA5," which calls for the presentation of ratemaking data for last three years for which data is available.<sup>8</sup> The CA-RA5 form is supported by 20 exhibits reflecting the calculation process for the loss ratio method.

## 6. The SCPIE Rate Hearing and Decision

SCPIE is one of several monoline medical malpractice insurers in California. In September 2002, SCPIE filed a rate application seeking a 15.6% rate increase for medical malpractice insurance, which is a commercial line of business.<sup>9</sup> The background of the case is interesting, as the Department initially approved SCPIE's rate application on the last day of the 45-day public notice period for rate applications under Insurance Code section 1861.05. On that same date, the Foundation for Taxpayer and Consumer Rights (the "Foundation") submitted a Petition for Hearing, arguing that SCPIE should **reduce** its current rates by 5.6%, a differential of more than 20 percentage points from the insurer's requested rate. The Department ultimately granted the Petition as the Foundation's request was filed timely and SCPIE's requested rate was in excess of the 15% threshold for mandatory hearings in commercial lines. The Department did not actively participate in the rate hearing, allowing SCPIE and the Foundation to make their respective cases.

The California rate hearing procedure calls for the parties' testimony to be submitted in written form prior to the hearing. Initially, SCPIE's direct written testimony followed the standard of review adopted in previous prior approval rate hearings, arguing that the requested rate was reasonable based on standard actuarial principles. The Foundation argued that no rate increase should be granted based on a strict application of the formula. In a pre-hearing ruling, the court determined that it would not rely on past practice, but that it was bound to apply the

existing regulations and formula while allowing general actuarial principles to support each generic factor not adopted by the Commissioner.

In compliance with Judge Rasmussen's request, SCPIE presented two scenarios utilizing the formula. The first applied the formula using actuarial analysis for the generic components. The second also used the formula. It applied those factors used historically by the Department in reviewing rate applications for the generic components. The court ultimately determined that it would not rely on the Department's historic generic factors, but would base its determination of the generic factors on actuarial standards.

Ultimately, the court determined that an increase of 9.9% was reasonable. The decision turned on the development and trending of losses, the treatment of tax credits on prior years' losses and the appropriate rate of return.

In arriving at the 9.9% indicated rate, the court applied the percentages or factors attributed to each of the ratemaking elements and inserted them into the formula, with the result reflecting the 9.9% indicated rate change.

## **7. Effects of SCPIE**

The SCPIE case was the first contested rate application to proceed to hearing in a number of years, and therefore it presently stands as the sole example of the method that the Department's Administrative Hearing Bureau will use to evaluate contested rate applications. There are several principles that can be derived from the case in addition to the findings stated above. The first is that in contested rate application cases, the court will apply the regulations and the formula strictly and will be hesitant to exercise discretion. In that regard, the Commissioner has designated the standard of review used in the case as precedent. Under that standard, the court must apply the regulatory formula to review the proposed rate request based on evidence that is submitted in the proceeding. Where the Commissioner has not adopted the generic determinations, the court concluded that values can be selected using generally accepted actuarial principles, expert judgment and standards of reasonableness.

Second, evidence will be submitted during the hearing that supports the insurer's rate request. This evidence is not restricted to the data contained in the original rate application. Rather, insurers are free to present their best case using all credible, available evidence to support the reasonableness of the requested rate.

Third, we learned that based on the regulations and the formula, the court will fairly attempt to assess all of the evidence presented to it. Therefore, the credibility of the evidence presented on those areas where the formula affords the opportunity to do so is crucial. Accordingly, insurers should maintain documentation that clearly shows the methods and data used to arrive at values inserted into the formula. Further, due to the complexity of rate cases, the credibility and experience of actuarial and economic experts can have a profound effect on the case.

Finally, the Commissioner did not deem the court's determinations with respect to the formula calculation as precedent. Therefore, the court's determination of the values used to arrive at the generic factors will not necessarily be used in the next case. However, the court did use the insurer's own data, rather than industry data, to determine the values to be inserted for several generic factors, as it did with respect to trend. Therefore, we would expect that in subsequent cases the court also would look to the insurer's own data where available and credible.

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**Robert W. Hogeboom** is a senior partner with the law firm of Barger & Wolen. He has been an insurance regulatory specialist for 28 years, dealing in all aspects of insurance regulatory law, including transactional work, financial analysis, market conduct examinations, rate filings and administrative hearings, disciplinary matters and insolvency issues. He has represented numerous insurers and producer clients on regulatory matters. Mr. Hogeboom has been a member of several California Department of Insurance task forces and is one of the founding members of the Federation of Regulatory Counsel, a national group of prominent insurance regulatory counsel and a member of the American Bar Association, Tort and Insurance Practice Section.

\* **This Article is co-authored by Robert J. Cerny. Robert J. Cerny**, born Los Angeles, California, May 24, 1966; admitted to bar, 1992, California. Education: Boston College (B.A., 1988; J.D., 1992). Associate Editor, Journal of Environmental Assessment Policy and Management. Co-Author: “Strategic Environmental Policy and Law”, Volume 22, Number 3 (1992). Member: State Bar of California. **Practice Areas:** Insurance Transactions, Insurance Market Conduct Examinations, Insurance Industry Regulation, Insurance Administrative Hearing Practice, Agent & Broker Licensing Issues, and General Corporate.

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<sup>1</sup> *In re the Rate Application of American Healthcare Indemnity Co. et al.*, File No. PA-02025379, Aug. 22, 2003.

<sup>2</sup> See Title 10, California Code of Regulations, § 2644.1 *et seq.*

<sup>3</sup> Proposition 103 did not apply to workers’ compensation insurance as rates for that line are separately regulated.

<sup>4</sup> *20<sup>th</sup> Century Insurance Company v. Garamendi*, 8 Cal. 4t 216, 251 (1994).

<sup>5</sup> *20<sup>th</sup> Century*, *supra* at 275-76.

<sup>6</sup> *20<sup>th</sup> Century*, *supra* at 319-20.

<sup>7</sup> *Dawson*, *supra* at 4.

<sup>8</sup> See 10 CCR section 2642.6 (setting as the default recorded period the most recent three years for which reliable data are available).

<sup>9</sup> A hearing is required for commercial lines upon timely request if the proposed rate adjustment exceeds 15%.