EXCERPT FROM PROPOSITION 103 TESTIMONY

Robert Bailey

2. How do you recommend that the Insurance Commissioner approach the definition of "Fair Rate of Return" for the purposes of deciding which insurance companies are exempt from the 20% rate rollback mandated by Proposition 103?

I recommend that the Commissioner first establish a target rate of total return on net worth return that is

comparable to fair rates of return for other industries of comparable risk.

Second, the Commissioner should use the profitability formulas and methodologies adopted by the National Association of Insurance Commissioners (NAIC) to convert the total return on net worth to a target operating return expressed as a percentage of net earned premium for all property and casualty lines regulated by Proposition 103. Third, once a target insurance operating return is established, it would then be possible to require each individual insurer group to calculate its property and casualty insurance operating return for California for the period November 8, 1988 to the year ending November 7, 1989 using the NAIC profitability methodologies and formulas. If California specific expense data is available for an insurer group that data should be used rather than the NAIC expense allocation procedure. Since California requires insurers to report data on a calendar year basis, it would be appropriate to use calendar year 1989 or a weighted average of calendar years 1988 and 1989 to approximate the period November 8, 1988 to November 7, 1989, in order to facilitate obtaining and verifying the data.

If the insurer group's operating return for all property and casualty lines covered by Proposition 103 for the period does not exceed the target operating return plus a margin for normal variation, it can be concluded that the insurer did not

earn in excess of a fair rate of return and, therefore, no rate rollback would be required. If the insurer group's results for the period exceed the selected industry-wide target operating return plus a margin for normal variation, then a rate rollback would be required unless the insurer can demonstrate in an individual company hearing why its unique circumstances justified the rates of returns it actually achieved.

Any rate rollbacks that are required pursuant to this procedure would be limited to a one-time return of premiums determined to be excessive for the period November 8, 1988 to November 7, 1989 and should not affect the rates each insurer had in effect in California subsequent to November 7, 1989. In my opinion, it would be inappropriate to use this rollback procedure to modify the rates each insurer had in effect subsequent to November 7, 1989 because it focuses only on the actual results for the rate rollback period, based on actual earned premiums and incurred losses and expenses during that period. It is inadequate and inappropriate as a basis for prospective prior approval regulation for any subsequent period, because, among other things, it does not reflect the actual rates in effect on November 8, 1989, nor any changes in inflation, claim frequency, cost severity, distribution of risks by class and location, or distribution of coverages and limits.

If the rollback is based on aggregate summary retrospective data for premiums earned and losses incurred during any period of 12 months as the NAIC Profitability formulas require, the percentage of rollback is not relevant to the rates in effect at the end of that period. The summary data used in the NAIC approach includes data from policies written at many different rate levels over about a two year period. Furthermore, even if no rate changes had occurred during that two year period, the rates for the next year should not be based solely on the data for the previous year; premiums, losses and expenses would need to be adjusted to anticipated levels.

Consequently, if summary retrospective data is used for determining the rollback, any rollback percentage would not be a valid adjustment to the rates in effect at the end of the rollback period. Thus, any rollback amount determined to be owed under the procedure I recommend must be treated as a fixed dollar amount, not a rate change.

The only valid way to evaluate and adjust the rates in effect after the rollback period is to use the normal prospective ratemaking procedures in full detail.

3. **What are the NAIC Profitability formulas and methodologies and why are they the most appropriate approach to use in calculating a reasonable target operating return and making the rollback determination?**

The NAIC is a voluntary association composed of the state insurance regulatory authorities of every state, including California. The organization promotes uniformity and quality in insurance regulation and the exchange of regulatory information. Among other things, the NAIC produces reports on insurer profitability and on the financial condition of insurers.

The NAIC profitability methodologies and formulas were first developed in 1973. They were adopted by the NAIC, which is an organization independent of both the insurance industry and consumer groups. The NAIC profitability methodologies and formulas have been in use for more than seventeen years, have the consensus of insurance regulators as being a good and reasonable way of measuring insurer past profitability and converting insurer operating returns to a measure of return that is comparable with other industries of similar risk.

The NAIC produces two types of reports each year on the profitability of the insurance business. One of these NAIC reports measures rates of return for each insurance company on a net basis after reinsurance for all lines combined countrywide. The second type of NAIC profitability report

measures insurance operating return on direct premiums for the industry by line, by state.

The NAIC profitability methodologies on which these two reports are based provide a way to calculate the actual rate of return as a percentage of net worth on an estimated GAAP basis for the property and casualty insurance industry for all lines of insurance combined countrywide. These results can then be used to compare insurance industry profitability with the profitability of other industries.

The NAIC also recommends a methodology for converting a rate of return on net worth to an insurance operating profit as a percentage of premium. This methodology is based on defined terms including "mean net worth," "overall operating income," "insurance operating income" and "underwriting income." A copy of the publication Using the NAIC Profitability Results (1988 Property and Liability Edition) is included as Attachment A. This document contains the NAIC profitability formulas, methodologies and definitions on which I have relied.

The NAIC profitability formulas and methodologies could provide the Commissioner with a recognized and tested basis to determine a target rate of return for all insurer groups and all lines of property and casualty business regulated by

Proposition 103. The target should be an operating return expressed as a percent of premiums, which is equivalent to an appropriate target total rate of return on mean net worth for reasons which I will describe shortly.

This operating return as a percentage of premium provides a consistent basis for measuring the relative profitability of the property and casualty insurance business across various lines of insurance and states. The linkage or relationship between the insurance operating return on premium and the total return on net worth is readily determinable using the NAIC profitability approach.

Using the NAIC profitability methodologies and formulas is simple, provides ease of administration and avoids the necessity of having to reinvent the wheel.

Use of an industry-wide operating return as a percent of premium to define target rate of return for the purposes of implementing the provisions of Proposition 103 would not affect each individual insurer's actual premium to surplus ratio. It would not affect the investment results and capital gains and losses derived from investing each insurer's surplus. It would not require arbitrary allocations of insurer surplus. It would focus entirely on premiums and the investment income derived from investing funds that correspond

to unearned premiums and unpaid losses. At the same time it considers investment income on surplus because the operating return is directly derived from a total return on net worth that is appropriate in comparison to the total returns of other similar industries. Thus, the approach mathematically reflects all investment income as required by Proposition 103.

4. **Does the NAIC-based procedure you recommend require the use of artificial leverage norms or does it rely on the actual capitalization present in the industry during the rollback period? Why is this desirable?**

The procedure I recommend does not use artificial leverage norms. It uses actual average leverage for the industry to establish the operating return on premium and applies that operating return to the rollback period. It thereby uses the actual capitalization present in the industry during the rollback period.

This is desirable because it uses actual conditions in the industry during the rollback period rather than hypothetical or artificial leverage norms for each company and for each line retroactively. It avoids penalizing or rewarding companies that had more or less capital than average. More than any other approach, it creates a level playing field for all insurers regardless of their individual level of capitalization.

The procedure I recommend uses all the investment income from capital, loss reserves and all other sources to establish a fair rate of return which is applied equally to all companies regardless of their individual capitalization. Unlike the leverage norms proposed by the Department of Insurance, the procedure I recommend uses all investment income from loss reserves and unearned premium to reduce rates. It allows the same incremental return on capitalization that is above or below average, which incremental return is only the investment yield on the incremental capitalization.

5. **Should the NAIC profitability methodologies and formulas be used to calculate rate changes, as opposed to a target operating return, for the purpose of prospective rate regulation?**

To my knowledge, the NAIC profitability methodologies and formulas are not followed for purposes of regulation of prospective rates in any of the other states that regulate rates. To the extent that the NAIC profitability methodologies involve a retrospective evaluation of actual results for the purpose of "evaluating whether competition is effective in regulating prices in the insurance business they should not be used for prospective rate regulation." In a letter dated February 3, 1989 regarding the NAIC Report on Profitability By Line and By State, the President and Vice

President of the NAIC said,

> It also should be noted that these exhibits provide evaluations of past performance. Prospective rates and future operating results are dependent on many variables other than historical results.

Making rates prospectively in a competitive market for each insurer by coverage requires vastly more information than summary results for one year for one insurer for one state for each line of business. There are substantial differences between the rollback procedure I recommend using and ongoing prospective ratemaking.

In actuality we now have the benefit of hindsight for the rollback period. So for the rollback period we have both the usual information that was available and was used at the time those rates were made and also the actual results that occurred during that period. The availability of actual results provides an opportunity to verify and simplify the review of the rates in effect during the year covered by the rollback.

However, ratemaking is prospective. It is an estimate of the future. From the nature of insurance, actual results are not known at the time rates are set. Rates are set prospectively based on all relevant information available at the time. This process is very detailed and complex because

of the many necessary variations by classification, by coverage, by limit of coverage, and by amount of insurance. Each insurer is different and its rates must reflect its own expenses, service and underwriting practices.

A review of actual results is retrospective. It has little meaning for the evaluation of individual risks, except for merit rating purposes. But in large aggregates actual data can be used to evaluate some of the forecasts incorporated in each individual rate. But even actual data for large aggregates is not fully credible as an evaluation of the expected results. Broad aggregates provide a simpler way to review the thousands of classes and coverages simultaneously, but are not an adequate basis for adjusting present or prospective rates by class and coverage.

The financial or profitability data contained in the NAIC Reports represents a summary of actual results. It focuses on hindsight in the aggregate. Ratemaking focuses on the detail by class and coverage and focuses on forecasting the future rather than summarizing the past. Ratemaking often uses a broader base than one company or one state or one year, and often uses external non-insurance data. Ratemaking also uses credibility procedures to allow for a normal range of variation in any statistical data that is used.

6. **Why is an operating return expressed as a percentage return on sales the appropriate measure for what constitutes a fair rate of return rather than some other measure?**

An operating return is the appropriate measure for rollback determination because it can be used to adjust premiums, while a rate or return on net worth, standing alone, cannot. A rate of return on net worth is an appropriate basis for determining a target rate of return for owners and investors for insurance in comparison with other industries that compete for investment capital. It is relevant to owners because it measures the return on the amount or the value of their investment. It is comparable to other industries because all are measured on a reasonably consistent basis. However, it cannot be used to adjust premiums without a proper basis for converting the return on net worth to a return on sales.

Thus, an operating return expressed as a percentage on sales or premium is the measure most recognized in and by the insurance industry to change prices for consumers. The percentage return on sales varies significantly from one industry to another to reflect variations in capital costs, risks, and other relevant factors. So the rate of return on sales cannot, by itself, serve as a basis for comparing insurance with other industries to determine a target rate of return. Consequently, a target total rate of return must be determined on the basis of the return on net worth for owners

and then converted, for purposes of the rate rollback determination, to an equivalent return on sales.

7. **What are the appropriate measures of equity for a property and casualty insurance company that can be used to compare insurance company rates of return to returns in other industries?**

In order to determine a target rate of return, the insurance business must be compared to other competing opportunities for investment. So the measures used must be comparable to those used in other industries. The common measures used in all industries by investors are Generally Accepted Accounting Principles, or GAAP, the measures used by the accountants who operate under the supervision of the federal agencies that regulate the securities markets.

Statutory accounting as it is applied to insurance company operations by state insurance regulatory agencies is not comparable to GAAP, is not appropriate for comparing rates of return, and is designed primarily for the purpose of insurance company solvency regulation.

The NAIC profitability reports adjust both statutory income and statutory surplus to estimate a GAAP basis. The 1988 NAIC profitability report states:

> The purpose of the report is to establish uniform standards for measuring the profitability of property

and liability insurance companies (individually and for all companies collectively) on a basis which will facilitate comparisons with other businesses and industries.

The data reported in the NAIC Annual Statement by each insurer has been adjusted by formulas adopted by the NAIC to estimate a "going concern" or "generally accepted accounting principles" basis. This is done because the NAIC Annual Statement is primarily aimed at representing the data needed for the regulation of solvency and hence in some important respects is more conservative than normal "going concern" accounting.

However, GAAP accounting is normally done on a parent company basis, including consolidated results for all subsidiaries. Accordingly, GAAP results are not available for many insurers, such as those that are subsidiaries of non-insurance companies. But the NAIC methods for estimating GAAP results are a good, workable approximation, and have the consensus of government regulators and the industry.

For these reasons, I believe that the procedures for estimating GAAP income and GAAP net worth contained in the NAIC Profitability Reports are the most appropriate basis for comparing rates of return for insurers with rates of return for other industries.

8. **For purposes of determining an appropriate target rate of return should insurance company returns be measured on a group basis, company basis, line basis or some other basis?**

The GAAP results that are published for other industries are all on a group basis. This is consistent with the way

investors view investment opportunities and results. They view the entity as a whole including all subsidiaries on a consolidated basis. The GAAP data that is available for the insurance industry is also on a group basis. Since many insurers are subsidiaries of other entities, their GAAP results are not available separately, except in unusual cases. That is why the NAIC has adopted procedures for estimating GAAP for insurers. Therefore, for comparing insurers with other industries, group data is the most appropriate basis for comparison. This is also the only way to avoid double-counting portions of income and portions of surplus.

If a company basis is used, the same surplus and income of a subsidiary insurer may be counted in the data for the parent insurer. Furthermore, the results of subsidiary insurers are not comparable to the results of insurance groups. The surplus needs of subsidiary insurers are less, all other things being equal, than insurance groups because the subsidiaries have the additional resource of financial support from their parent when needed, a resource that insurer groups do not have. As a result, a subsidiary insurer can maintain a comparable level of financial security with less surplus than a stand-alone insurer of the same size. Accordingly, rates of return on a company basis for insurers are not comparable to rates of return for other industries which are all measured on a group basis.

Similarly, a line of business is even less appropriate for measuring a fair rate of return because there is no generally accepted way of doing so. On a line of business basis, surplus is not available and must be allocated from the company or group total. Any allocation of surplus is artificial and does not provide a level of financial security for any line that is comparable to the group as a whole. For a group or company, the entire surplus is available to support each line of business. If one line of business has unusually bad results in the short-term, the entire surplus for all lines is available to guarantee performance for the one line in momentary difficulty. Allocating the surplus to each line fails to recognize the use of each of those allocations to support the other lines, and also fails to recognize that many such allocations would be inadequate to support the line to which they are allocated on a stand-alone basis.

Likewise, income on a company or line basis is not comparable to income on a group, all lines basis. Lines and companies are often interrelated in the insurance marketplace in the way they are managed, financed and reinsured. Accordingly, the allocation of net income to companies within a group, or to lines within a company, is not comparable to the net income that would be realized on a stand-alone basis for any company or line.

In addition, the lines and companies within a group may support each other whenever there is a short-term deficit in any line or company. The profits for all lines and companies within a group are likely to be available to cover the short-term deficits in any line or company. Allocating income to each line or company within a group fails to recognize the use of the amounts allocated to support the other lines and companies that may be in momentary deficit, or which may fortuitously produce less net income than is needed.

9. **What reference points should the Commissioner use in establishing a rate of return on GAAP net worth that is an appropriate target rate of return for the purposes of implementing Proposition 103?**

There are various reference points, none of which is determinative by itself.

The average rates of return for other industries of similar risk over similar time periods provides one initial reference point. So also are the current costs of raising new capital for insurance or other industries of comparable risk.

Another reference point is the rate of return currently used in California for other regulated industries, such as public utilities. However, a target rate of return for a

competitive industry such as insurance should be higher than for a monopolistic, non-competitive industry such as public utilities because insurers lack the guarantees of market and price that public utilities have.

I am aware that the Department of Insurance has advocated reference primarily if not exclusively to an historical average return for the insurance industry. The Department's view does not appear to be based on an even number of full underwriting cycles, however, which creates a probable distortion in the Department's result. While average return for a complete underwriting cycle or for two complete underwriting cycles provides information that, if modified to reflect current interest rates, ratios of market value to book value, and other industry conditions, should be considered, the average return for the insurance industry, or for any industry, is an inadequate basis for measuring the cost of capital or the rate of return necessary to attract or retain capital. An industry average includes some companies that are on the road to bankruptcy or are withdrawing from business due to failure to achieve results sufficient to make it attractive to stay in business. Industry averages are suitable to compare industries but are inadequate to determine a rate of return sufficient to attract and retain capital. Very few investors would be willing to invest capital if they had to assume they would achieve results only equal to the average

for that industry.

Is the approach you propose consistent with the recommendations and analysis contained in the NAIC Study of Investment Income?

It is consistent with that study. The NAIC study included the following recommendation and findings:

> "The task force recommends that the ratemaking/rate-review process include a measure of profitability based upon a total return to equity analysis."
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> "The task force has not been able to find any economic justification for the traditional five percent profit allowance ... the margin for profit and contingencies traditionally allowed in the ratemaking formulas for most lines of insurance ... is allowed in addition to all of the investment income earned by insurers ... ."
>
> "Net worth is also the base upon which a target rate of return should be selected... . Once a target return has been selected, it can be compared with the estimated return from sources other than underwriting to determine the margin needed from underwriting."

The approach I propose is based on a total return to equity analysis as recommended by the NAIC Task Force. The net result of my approach is that all of the profit allowance is derived from investment income, including both the investment income earned on equity and the investment income from operating reserves. The operating return on premium includes investment income on operating reserves which historically has equalled, for all lines combined, at least 5% of premiums. The result is that in my approach, if one

determines that an operating return of 5% or less is equivalent to a reasonable total return to equity, nothing is proposed for underwriting profit, down from 5% from the traditional underwriting profit allowance that was rejected by the NAIC Task Force. The operating margin on premium is derived from the target rate of return on net worth consistent with the NAIC recommendations.

11. **Should the target rate of return based exclusively on one or more of these reference points constitute a cap on an individual company's allowable return for purposes of the rate rollback determination?**

No. None of these reference points taken alone can be said to be an adequate measure of what constitutes a fair rate of return for the purposes of the rate rollback procedure.

The NAIC in its profitability report states:

> When reviewing these results it should be remembered that there is often substantial fluctuation from one year to the next, both for the industry aggregates and especially for individual insurers.

Accordingly, it is appropriate not only to focus on a target rate of return that is expected or allowable in the premium rates, but also, when reviewing the actual results incurred in one year, for one group of companies, for one state to allow for reasonable fluctuation of actual results

above the expected result.

If the expected result or target rate of return is used as a cap on profits for each company each year in each state, the actual average rate of return will be much less than the expected average. Consequently, it would be confiscatory to use the target rate of return as a maximum rate of return. Under such a limitation, investors would have an expected rate of return much less than the target rate of return and, therefore, the rate of return could not be considered fair.

12. What is an appropriate way to allow investors a reasonable prospect of achieving a fair rate of return for purposes of the rate rollback?

Any artificial ceiling on profits will reduce the expected average to some degree, but there must be some balance between reasonable fluctuations above the expected average and the possibility that a high actual rate of return may reflect a high expected rate of return for that insurer. I believe that any maximum for actual results that is less than the target rate of return plus a margin for normal variation would not be a fair rate of return and would be confiscatory because its impact would be too substantial to be ignored by investors.

Thus, I recommend that once a target industry-wide operating return is selected, a reasonable margin for actual

results must be allowed above the target for any individual insurer that exceeds the industry-wide operating return. A margin for normal variation corresponding to one standard deviation would be the minimum margin to establish a fair rate of return and to avoid a confiscatory result.

A "standard deviation" is a standard statistical concept that is universally recognized and used as a measure of fluctuations around an expected mid-point or average. Under normal circumstances, actual results will exceed the mean plus one standard deviation about 16% of the time, or about once in six cases.

13. Why should one standard deviation be used?

An allowance for variation in addition to a target rate of return, or normal allowance for the cost of capital, is necessary to avoid a confiscatory result. It would be confiscatory to apply a retrospective evaluation in only one direction--refunds when results are better than expected, but no loss recoupment when results are worse than expected. One standard deviation is a reasonable and necessary allowance for normal variation.

A standard deviation is the accepted statistical measure of a normal amount of variation. It is similar to the concept

of an average variation. It defines a normal range of actual results that includes about two thirds of all likely cases under normal circumstances.

The question posed by the rate rollback provisions of California's Proposition 103 is whether each insurer's rates in California during the year ending November 7, 1989 produced rates of return that were more than fair. The answer to this question will never be known with complete certainty for each insurer group even though actual experience is available because actual experience is not a fully reliable answer to this question.

Actual results are fully reliable and credible as to what happened. But what actually happened is not fully indicative of what reasonably was expected to happen, or what might happen next time for the same business. For example, consider one policy of fire insurance on a house. Suppose the actual result for one year was that no fires occurred. That fact should not entitle the policyholder to a full refund of the entire premium. The actual result was not fully credible or indicative of the average expected result over a longer time period. As the volume of data included in the actual result gets larger, the normal variations get smaller. But even all the data for one insurer in one state for one year is not fully indicative of what might have happened, or what

reasonably was expected to happen, or would happen again on the same business.

Due to this lack of credibility of actual results for one year, one state, one insurer, it is not possible to be absolutely certain that any one definition of "fair rate of return" is absolutely correct in all instances. Therefore, the Commissioner should adopt a definition of fair rate of return that reflects this uncertainty. The use of one standard deviation is, in my opinion, a reasonable way to balance the competing types of errors inherent in any one definition of fair rate of return that the Commissioner may adopt.

When a target operating return is used in conjunction with a margin for normal variation, if the actual rates were not excessive, the mistake of rejecting them as excessive will be made about 16% of the time which is about how often actual results will exceed the mean plus one standard deviation. If the actual rates were excessive, the mistake of accepting them as not excessive will be made more or less than 16% depending upon how excessive they were.

Other standards to reflect the uncertainty caused by the lack of credibility of results for one year, one state and one insurer are less desirable. For example, if a range

corresponding to two standard deviations is used in a definition of fair rate of return to reflect uncertainty, the chance of rejecting rates as excessive when they are not is reduced to about 2%, but the chance of accepting excessive rates is greatly increased. If less than a normal range corresponding to one standard deviation is used the reasonable expectations of investors will be too severely compromised. Lower allowances for uncontrollable variations will make too large an impact on the expected average result to the point where investors will not be able or willing to ignore it because their expected average would be too far below a reasonable average. So a reasonable balance has to be established. In this case, a normal range corresponding to one standard deviation appears to be the best compromise.

The allowance for normal variation will be less if all lines of insurance are combined and will be less for groups rather than individual companies.

14. **How can one standard deviation for the California property-casualty insurance operating returns for insurer groups be calculated for purposes of the rate rollback procedure that you recommend?**

Results of relatively small insurers, including groups with small annual premium volume, can vary widely with the result that the standard deviation is likely to be distorted because the distribution of actual results will not be a

"normal" distribution. It is statistically appropriate, therefore, to exclude these results in order to ensure a more "normal" distribution.

Accordingly, I recommend that a normal distribution be approximated by using data for insurers with a market share in California of at least 1/2 of 1% (about $150 million in premiums) and estimating from that data a deviation at which 16% (the proportion expected in a "normal" distribution) of these insurers can be expected to exceed the mean plus the deviation because of uncontrollable variations.

The deviation which identifies the 16% of insurers that are beyond the mean plus the deviation is about 6%. The mean operating profit, as reported in Best Aggregates and Averages for 1988, is approximately 4% for all lines combined. This means that 16% of insurer groups had a loss of more than 2% and 16% of insurer groups had an operating profit of more than 10%. In other words, the normal range, which included about two thirds of all insurers, was thus from -2% to +10%. Outside that range the results could be described as outside the normal range.

Smaller insurers show greater dispersion. So smaller insurer groups should be allowed a larger deviation or should be exempted from the rollback procedures because of lack of

sufficient credibility in their own data for one year.

15. **Is it reasonable to conclude that a rollback of an insurer's rates would be confiscatory unless the actual profit during the rollback year exceeded the expected average profit plus a margin for normal variation?**

Yes. That conclusion is reasonable for California for the years 1988 and 1989, the period in question here. The operating return as a percent of premium, including investment income and federal income taxes, for all lines and all insurers in California, as published by the NAIC was 2.0% in 1988. It can reasonably be expected to be less than 2.0% for 1989 due to the earthquake and the freeze on rate increases. These California returns are less than countrywide returns for the same period and are less than that which is equivalent to an industry-wide fair rate of return on net worth.

Because the average return for the industry in California was not excessive, it is reasonable to assume that each insurer's rates were also reasonable unless its actual results provide a statistically reliable indication that the results exceeded the normal range of statistical variation. A reasonable estimate of a normal variation for insurers with a market share of at least 1/2 of 1% in California is 6% in addition to the reasonable target operating profit as a percent of premium.

To use a smaller allowance for normal deviations would depress the target operating profit too materially. Since the actual average return during the rollback period was inadequate to support the fair cost of capital, to depress that average even further would be confiscatory.

16. **Is the concept of a margin for normal variation or one standard deviation a concept that has been used in insurance regulation or within the insurance industry before? If so, describe how the concept has been employed?**

The concept of a margin for normal variation has been included in every single statute or regulation with which I am familiar dealing with the return of excess profits. These statutes and regulations include those currently in effect in New York, Florida and New Jersey. These statutes and regulations contain an amount or method of determining a target or reasonable rate of return based on three to six years of financial results. Even though a multiple year measurement is performed which reduces the normal variation, they also include a threshold amount above the target rate of return that must be exceeded prior to the determination that a refund of excess profits is appropriate. The threshold amount in these excess profits laws and regulations is roughly equivalent to the concept of normal variation that I am recommending here.

17. Should the industry-wide all lines operating return be applied absolutely or should individual insurers whose results fall above the target return be permitted to justify higher returns based on individual circumstances?

An industry-wide all lines operating return represents averages for many insurers whose data were used in the calculation. Any particular insurer will have needs and risks that are different from industry averages. For example, the cost of capital will be different for every insurer. Individual insurer variations should be recognized when they are material both for purposes of the rate rollback procedure and prospective rate regulation. Unique circumstances that might justify a higher allowance for profit in California than the all lines target operating return adopted by the Commissioner include but are not limited to the following:

1. The purchase of less reinsurance than industry average;
2. Exposure to greater catastrophe hazards than industry averages;
3. More volatile lines of business than industry averages;
4. Less spread of risk than industry averages;
5. Larger loss reserves in relation to premium than industry averages; and
6. Larger than average growth.

18. **Should premium to surplus leverage norms for individual insurers or lines of business be used in implementing the provisions of Proposition 103?**

No.

There are two defects in applying artificial leverage norms to individual insurers and lines of business for measuring a fair rate of return. They are inconsistent with historical rates of return based on different leverage ratios because the historical rates of return would have been different if leverage had been different. And they would be confiscatory for any insurer whose actual surplus exceeds the artificial norm. Under the approach I am suggesting, a separate determination of an appropriate leverage norm for individual companies or groups of companies or specific lines of insurance is unnecessary.

A fair rate of return is proportional to the degree of risk. As risk increases, the rate of return required by investors will also increase in order to compensate for the greater risk. Consequently, if artificial leverage norms are selected which are different from the average leverage used in the business, the actual rates of return for the industry are not relevant to the rates of return appropriate for the artificial leverage norms. Also, if the actual profits for an industry are related to a different net worth than what was actually used, the rate of return would have been different.

Consequently, actual rates of return are not relevant to a leverage ratio different from actual.

Use of different leverage norms by line of business necessitates an allocation of surplus. Allocation of surplus by state by line is inappropriate on any basis because such an allocation assumes that each company-state-line combination stands on its own without support from surpluses allocated to other states and lines. That assumption is not true and is likely to be prohibited by law if an attempt were made to implement it in actual practice.

To deprive an insurer of a fair rate of return on all surplus which was actually devoted to the business of insurance and provided benefits to the consumer during the relevant period would be confiscatory. Additional surplus reduces the risk of insolvency. It also reduces the cost of insurance to the consumer. Since policyholders have a call on all of a company's actual surplus and since that surplus was actually exposed to that call during the rollback period, the actual surplus in fact provided a benefit to consumers and must therefore be considered in the determination of a fair rate of return.

29. Does high leverage benefit investors in insurance companies or does it benefit insurance consumers? What are the benefits to insurance consumers of low leverage?

High leverage benefits only investors. High leverage is harmful to consumers.

Investors benefit from high leverage because it increases the rate of return on their investment. Higher leverage enables investors through the insurer to write more business and capture more profit on the same capital base. Investors also gain by being able to control more business without diluting their ownership and without borrowing money at high rates from lenders. Higher leverage also benefits investors by enabling them to gain greater economies of scale without any additional capital investment. The strong incentives that exist for investors to increase leverage are regulated by the statutes and regulatory structure that are aimed at setting maximums on leverage beyond which investors are not permitted to go.

Surplus in insurance is the guarantee of performance. It is what makes certain that insurance will truly be insurance. The guarantee provided by surplus is valuable to the consumer and costly to the investor. Investors generally prefer to provide as little guarantee as they are permitted by regulation and competition. Consumers generally prefer as much guarantee as they can get.

Higher leverage is detrimental to consumers not only in reduced security from the hazards of insolvency, it also tends to increase the cost of insurance. A highly leveraged insurer

must spend more to attract business in competition with other insurers who have stronger security. This means more cost for advertising and commissions to agents. Highly leveraged insurers must also buy more reinsurance which is a form of renting surplus. But the costs of reinsurance are high. Insurers with greater amounts of reinsurance must price their insurance higher to cover the extra overhead and margins of the reinsurance that they purchase.

It is also important to note that allowing or requiring high leverage encourages gamblers to enter the insurance business. If they win, the gamblers take the winnings. If they lose, all insurance policyholders take the losses. If gamblers are permitted or encouraged to write insurance with very little of their own money at stake, the potential gains from a highly leveraged business are large enough to attract gamblers to enter the business.

30. **If individual company premium to surplus ratios are regulated in a fashion that encourages and rewards higher leverage, is this likely to result in reduced insurance rates for California consumers in the long-term?**

It is likely to result in higher insurance rates for California consumers in the long term. Reduced capitalization means a reduction in the available supply of insurance and economic theory would predict that a reduced supply with no corresponding reduction in demand is likely to result in an

increase in prices. Also, this type of regulation will pressure insurers with lower leverage to reduce growth or withdraw from California and their business will be turned over to higher leveraged insurers. Since some of the lowest ~~priced~~ leveraged insurers tend to have lower rates, their reduced participation or departure will cause an overall increase in the rates for California consumers.

Also, lower leveraged insurers tend to have lower costs for reinsurance and for acquisition of business. Higher leveraged insurers tend to have higher costs for reinsurance and acquisition of business, and in addition, they tend to have a significantly higher frequency of insolvencies and other regulatory problems which increases costs such as assessments for the state insurance guaranty fund and for additional regulation.

31. Is it possible to allocate surplus into categories of "needed surplus" and "surplus surplus?" Why would any such allocation be artificial and unreasonable?

No. California Insurance statutes define minimum surplus. All additional surplus is used and useful in providing greater security and lower and more stable prices for the consumer. So, any dividing line drawn other than at the statutory minimum surplus definition would be artificial and any line drawn that ignores the benefits provided by additional surplus would be unreasonable.

Furthermore, such a division is unnecessary. If a fair rate of return for rate regulatory purposes is defined in terms of an insurance operating return expressed as a percent of premium, there is no need to make the artificial attempt to divide surplus into needed and unneeded portions.

32. **Why is it desirable from a regulatory standpoint to develop a definition of fair rate of return that is independent of each individual insurer's actual premium to surplus ratio?**

It is desirable for the following reasons:

Cross Purposes

A maximum on surplus levels for an individual insurer for rate regulatory purposes is at cross purposes to the minimums on surplus levels used for solvency regulation purposes. For solvency purposes, regulators try to require or encourage stronger surplus levels in order to provide better assurances to consumers that their claims will be paid properly and timely. A target rate of return that is tied to a minimum premium to surplus ratio for individual insurers will create strong financial incentives to increase premium to surplus ratios above that minimum, which is contrary to the objectives of solvency regulation.

Unjustified Results

To vary premium rates among insureds for the same coverage depending on the premium to surplus ratio of the insurer effectively creates a situation where, all other things being equal, rates would be higher for insurers with less surplus, exactly contrary to the relative value of the coverage to the consumer.

For example, assume that the prescribed artificial leverage norm for two insurers is 3 to 1, and that they each write the same amount of premium but one insurer actually writes at 3 to 1 and the other is at 6 to 1. The latter has only half as much surplus as the former, and also has only half as much investment income from that surplus. In relation to premium, the latter insurer has less investment income and will be allowed to use higher rates to produce the same amount of total return from both underwriting and investment as the former. Both will relate their total return to the same leverage norm, i.e., one third of premium, and will have the same rate of return on that leverage norm. The latter will actually have twice the rate of return on actual surplus. This means that the latter insurer will be allowed both higher rates and a higher rate of return on actual surplus, even though both will have the same rate of return on the prescribed leverage norm. The security of the company writing

at 6 to 1 is less, because it provides only half as much surplus to guarantee its commitments, so its service is worth less, but its rates are allowed to be higher, contrary to its value to consumers.

Averages versus Particulars

The target rate of return on net worth should vary for every insurer and every other type of company depending upon leverage, risk and many other considerations. But the definition of target rate of return that I recommend for use in implementing the rate rollback provisions of Proposition 103 is determined on the basis of the actual average leverage for the entire insurance industry. This is done for practical reasons. If actual industry averages for leverage are used to determine a target rate of return on net worth, it is inconsistent and unnecessary to also establish a variable rate of return dependent on a different average premium to surplus ratio, when the actual average premium to surplus ratio was recognized in the calculation of the rate of return on net worth.

Actual rates of return on net worth for individual insurers do vary and should vary according to the individual company's premium to surplus ratio, which is a measure of its own leverage and risk. But those variations should be ignored

in developing an industry-wide standard for good, practical reasons. The use of actual industry averages is appropriate in converting average return on net worth to an average target rate of return on premium for the same reasons. The development of a definition of the appropriate target rate of return for an industry is difficult enough without introducing the added complexity and controversy of trying to develop different target rates of return for each company or each line of business dependent on variables as difficult to evaluate as leverage and risk.

To attempt to develop a rigid regulatory relationship between two variable rates of return as diverse and uncertain as the returns on net worth and sales, dependent on their inter-relationship with each other is at least impractical, if not impossible. And to attempt to develop a rigid regulatory relationship between one average return on net worth regardless of leverage and a variable return on sales dependent on leverage is inconsistent and inappropriate.

It is appropriate and sufficient to develop one average target rate of return on net worth and to convert it to one average target rate of return on premium that is independent of an individual company's surplus and the investment income derived from surplus. This allows each company the flexibility to work out the best relationship between premium

and surplus for its own circumstances in response to competition in both the capital markets and the insurance marketplace.

Delay

A rate of return that is dependent on each individual insurer's actual premium to surplus ratio introduces an additional level of complexity and controversy into the regulation of premium rates, and thereby, unnecessarily delays the regulatory process for premium rates and is likely to result in increased regulatory costs.

33. **Would imposition of premium to surplus ratios for the rollback determination as proposed by the Department of Insurance result in the taking of profits earned outside of California?**

Yes. If California requires rollback of a portion of the profits necessary to support the capital used to support the business in California, the company will be forced to meet its cost of capital needs from income earned in other states.

34. **Is there a fair and reasonable way to allocate surplus to a particular state or a particular line of business when a company operates in several states and engages in several lines of business?**

It is not fair or reasonable to allocate a company's surplus by state or by line. The amount of surplus needed to support the business in a state or line is not proportional to either premium or reserves. It is proportional to risk. Neither premium nor reserves are complete and satisfactory measures of all the risks an insurer faces. Even for the same line of business and equal amounts of premiums or reserves, the risk would vary by state because different states have different risk characteristics, such as different average sizes of claim costs, different average lengths of time to settle and pay claims, different maximum sizes of loss, different catastrophe potentials, and different regulatory delays for implementing needed rate changes.

If companies legally segregated their surplus for each line in each state, the resulting surplus in many instances would fail to meet statutory minimum requirements, and in many other instances would be inadequate to meet statutory requirements regarding the maximum net loss as a percent of surplus, thereby requiring drastic changes in reinsurance arrangements.

For example, no one could write California earthquake

coverage if all the surplus that could be used to support that line was the amount allocated in proportion to either annual premium volume or reserves.

35. **Why should a total return on estimated GAAP net worth that is determined to be reasonable based on comparisons with other industries of similar risk be converted to an operating return as a percentage of premium rather than relating the total return directly to sales?**

In Using the NAIC Profitability Results, (1988) page 3, the NAIC states:

> Overall operating income and total return are not related to sales because they include the investment income earned from investing the capital and surplus of the insurer. Such investment income would be earned regardless of how much earned premium the insurer takes on, and even if the insurer wrote no business at all. Hence it is not relevant to relate such investment income to earned premiums.

If an industry-wide rate of return on sales or premium is adopted by regulation and if that rate of return includes investment income earned from investing net worth, insurers who have small amounts of sales in relation to net worth will be forced to actually lose money on their insurance operations and will be allowed less total return than if they had no sales. That would clearly be unfair because if an investor is willing to assume the risks involved in the insurance business, the investor should be allowed to earn additional rewards commensurate with the additional risks. The investor

already has the risks of investing the capital. If the investor is to be encouraged to expose that same capital to the additional risks in selling insurance, an additional reward must be provided that is proportional to the amount of sales.

If investment income from investing net worth is included in a return on sales or premium and, if a uniform or minimum ratio of premium to net worth is prescribed, it will deprive insurers of a fair rate of return if they have more than the minimum capital prescribed, and it will therefore drive insurers to reduce capital and increase leverage; this will deprive consumers of the greater financial security and lower more stable rates provided by stronger financial safety margins. The fact that investment income on capital and surplus is not included in an operating return expressed as a percentage of premium does not mean that investment income on net worth or surplus is not considered for the purpose of comparing returns to other industries.

Consequently, a total return that is considered reasonable should be determined. From this total return an operating return should be derived by subtracting investment income on net worth and relating the remaining amount to premium. This operating return can be used as the appropriate measure of the incremental reward or return relevant to the

incremental risk reflected by the amount of insurance business written.

36. **Is it desirable from a public policy standpoint to develop a definition of fair rate of return that is expressed as an operating return on sales?**

Yes. First, it avoids any need to prescribe or limit the ratio of annual premium to surplus. So it is simpler and avoids a controversial issue.

Second, it avoids disincentives to commit stronger levels of capital to protect the security of the obligations to consumers to pay claims.

Third, it avoids the need to allocate surplus and investment income on surplus by state and by line of business, a complex and controversial process that is filled with estimates and uncertainty.

Fourth, investment income on surplus is unaffected by the amount of premiums written. Accordingly, premium rates should be unaffected by investment income on surplus. Investment income on surplus is relevant to the regulation of insurance rates only to the extent of determining a target rate of return to owners on their investment for the industry as a whole.

If the Commissioner's regulations require the use of investment income on surplus in combination with arbitrary leverage norms, is it likely that the regulation will compel the return of income on past profits?

Yes. The inclusion of investment income on surplus in calculating an actual rate of return for comparison with a target rate of return as a percentage of premium will require rates to be lower for insurers who have more surplus in relation to premium. This in effect compels the return of income on past profits.

For example, suppose the target rate of return on net worth is 12%, and the target ratio of premium to surplus is 3 to 1. The target rate of return on premium would be 4%. Suppose also that the 12% return on net worth consists of 6% after tax investment return on surplus plus 6% for operating income (other investment income and underwriting income) after tax.

An insurer with premium equal to surplus, i.e., writing at 1 to 1, and earning 6% after tax investment income on surplus, would be required to lose 2% from operating income in order to comply with the 4% target return on premium. (6%-2%=4%) An insurer writing at 2 to 1 would be permitted to earn 1% operating income on premiums (6%+2+1%=4%). An insurer writing at 3 to 1 could earn 2% from operating income

(6%+3+2%=4%). An insurer writing at 4 to 1 could earn 2.5% from operating income (6%+4+2.5%=4%). This illustrates how the investment income on surplus (past profits) can be used to increase short-term rate reductions. The more surplus, the greater the reduction.

It is unfair to make the size of the rate rollback depend on the amount of past profits the insurer has retained in the company to guarantee its future performance.

Also, it is important to note that the NAIC says it is not relevant to relate investment income on surplus to earned premiums.

42. Have you reviewed the testimony presented by the Insurance Department witness, Mr. Ray Bacon? If so, could you please comment on the approach to defining a fair rate of return that he recommends be adopted?

The California Insurance Department's proposal as outlined by Mr. Bacon is to establish leverage norms for each line of business and use these norms to fix profit allowances for each line of business. The effect of this is that the profit allowance for each line, as a percent of premium is inversely proportional to the leverage norm for that line. For example, the Department's proposed leverage norm for fire insurance is 5 to 1 and for medical malpractice insurance is 1 to 1. That means that the operating profit allowance for fire insurance, as a percent of premium, is one fifth as much as for medical malpractice insurance. For homeowners insurance the leverage norm is 4 to 1 which means that homeowners rates will be allowed one fourth the profit margin, as a percent of premium, as medical malpractice insurance.

In general, the leverage norms proposed by the California Department are inversely proportional to the ratio of loss reserves to premium. If loss reserves are high, the leverage norm is low, and the resulting operating profit allowance is

high.

The California Department's approach to defining fair rate of return creates a relationship between loss reserves and profit -- the higher the loss reserves, the higher profit as a percentage of premium. There is a relationship between loss reserves and the amount of investment income on these reserves, but why should operating profits be higher as a percent of premium just because investment income is more? The profit margin should not uniformly increased where investment income is higher, which is the result of the California Department's approach.

In effect, the California Department's approach assumes that the riskiness of a line of insurance is directly proportional to the loss reserves. Those lines with high loss reserves are assumed to be more risky and, thus, are allowed larger operating profit margins than those lines which have low loss reserves. In fact, the opposite may be true. A line might have high loss reserves, but a very predictable payment pattern (for example, periodic disability payments until age 65). On the other hand, a line may have low loss reserves, but be very risky. Earthquake coverage is an example. This line has relatively small loss reserves, but is extremely risky. Another example, would be property damage coverage in a hurricane area. When a storm occurs property damage claims

are likely to be paid fairly quickly, with low loss reserves on average over time. Yet this line is extremely risky. Fire and allied lines involve a greater use of reinsurance than any of the lines of business that have substantial levels of loss reserves, indicating that these lines have risks at least as significant as the liability lines. The Department is therefore using an arbitrary and overly simplistic approach to the complex problem of determining riskiness by line.

The Department's primary method of measuring risk, namely the magnitude of loss reserves in relation to premium, is inconsistent with the conclusions of the 1984 NAIC Study of Investment Income. That study defined the "three basic types of risk" for the property/casualty industry as: underwriting risk, investing risk, and leverage risk. It defined underwriting risk as "primarily the risk that the losses and/or expenses of underwriting will differ from the amounts anticipated at the time the insurance was priced." While the magnitude of loss reserves increases investing risk and also increases underwriting risk, there are other substantial sources of investing risk, and the occurrence of a loss is obviously a greater risk than the volatility of reserving for it after it has happened. Consequently it appears that the reserving risk is not considered a primary source of risk by the NAIC. The NAIC regards the pricing risk, the investing risk and the leverage risk all as more important.

The problems with the Department's leverage norms can be documented by the actual operating profits by line for the industry countrywide for the past ten years, including investment income on loss reserves and unearned premiums. These actual profits have, in fact, been inversely correlated with the profit allowances by line which would result from the California Department's proposed leverage norms. The correlation that I have calculated based on the chart contained in Attachment C is -.46. Over the past ten years, the lines with the most loss reserves, i.e., medical malpractice and other liability, have had much less profit than the lines with the least loss reserves; i.e., fire, allied lines, inland marine, burglary and theft, and boiler and machinery.

In summary, the leverage norms proposed by the Department place undue emphasis on loss reserves. In addition, they do not track with the market assessment of risk over the past ten years. In fact, the profit margins generated by the Department's proposed leverage norms are negatively correlated with actual results. Both actual results and actuarial theory support the conclusion that an approach based on a uniform operating profit for all lines of business would be a more reasonable and workable regulatory standard for implementing the provisions of Proposition 103 than the standards involving

varying profit allowances by line that are generated by the Commissioner's leverage norms.

It is also important to note that in his testimony Mr. Bacon supports the exclusion of investment income on the portion of surplus not allowed to be considered due to the artificial leverage norms for ratemaking or rollback. But the DOI Preliminary Prayer makes no reference to any exclusion of any part of investment income. Indeed, to exclude some investment income as Mr. Bacon suggests may conflict with Section 1861.05(a) . . . "the Commissioner shall consider whether the rate mathematically reflects the insurance company's investment income."

43. Do you agree that Mr. Bacon's estimate of 1.3 for the leverage norm for workers' compensation insurance is consistent with the leverage norms for other lines?

No. Mr. Bacon testified that his primary basis for measuring risk by line was the amount of loss reserves by line, and that a secondary basis was the volatility of the loss reserves for each line.

On Attachment C, I show the ratio (in percent) of loss reserves and loss adjustment expense reserves to written premium for each line. These ratios are correlated to California relative profit factors (which are proportional to the result of dividing the target rate of return on surplus

by the leverage norm for each line) by .94. Perfect correlation would be 1.00. No correlation would be zero. So they can be said to be correlated 94% with the relative profit factors. This confirms Mr. Bacon's testimony that the relative amount of loss reserves by line was his primary basis for setting the leverage norms.

Workers' Compensation ("WC") has less loss and LAE reserves than Other Liability. If a leverage norm for WC is based entirely on a comparison of loss reserves with Other Liability, the leverage norm for WC would be 2.77 to 1, compared to 2.0 to 1 for Other Liability. WC has less loss reserves so it needs less surplus and can write more premiums in relation to surplus. If a further adjustment is made for the volatility of loss reserves, the leverage norm for WC would need to be raised further, probably above 3.0 to 1 because, as compared to other Liability, WC has much less volatility. WC benefits are set by statute based on actual medical expenses, lost wages, and specific disabilities. Other Liability benefits are not fixed by statute and must be negotiated or litigated, which is a much more volatile and lengthy process.

If a leverage norm of 2.7 is used for WC, the average leverage norm for all lines including WC is 2.7, which is materially higher than the actual average in 1988 of 1.7 or

the long term average of 2.0. By Mr. Bacon's testimony, the average leverage norm should equal the long term industry average of 2.0 to 1.

44. Could you please comment on the approach to defining "fair rate of return" adopted and described in paragraphs 10 and 15 of the Department of Insurance Preliminary Prayer?

I have assumed that the 11.2% rate of return recommended by the Department of Insurance (DOI) is based on the average statutory returns for the insurance industry over about the past 15 years. This rate of return is equivalent to less than the return allowed in California for public utilities who have less risk. The DOI recommends that it be applied to a "Base Measure of Statutory Equity" which averages about 2.7 to 1, compared to the actual historical average for all lines of business of about 2.0 to 1 over the past 15 or 20 years. The rate of return of 11.2% on an artificial leverage norm of 2.7 to 1 is equivalent to about 8.3% on actual equity of 2.0 to 1. So the DOI takes an 11.2% statutory historical average and reduces it to 8.3% by reducing the base to which it is applied.

Then the DOI recommends using that average rate of return as a cap on allowable profit. That means that about one half of all companies will be capped at the average and the other half will have actual results worse than the average. This

will reduce the average even further, to a rate of return of about 1.8% on actual equity for the very largest companies (premium in California of at least $150 million), and to a negative amount for smaller companies. (This conclusion assumes a normal distribution. Limiting each company to the average reduces the average by 40% of one standard deviation. The standard deviation for the very large companies is estimated to be about 6% for operating returns on premiums. Converting 6% operating return on premiums to a return on equity at 2.7 to 1, gives 16.2%. Multiplying by 40% gives 6.5%. Reducing 8.3% by 6.5% gives a capped average rate of return on equity of 1.8%.)

So the effect of the DOI's use of an artificial base measure of statutory equity combined with capping each company at a maximum of 11.2%, will produce an actual industry average return on actual equity of 1.8% for large companies (even less for smaller companies who have larger standard deviations). This is clearly a confiscatory result for the industry as a whole.

45. Could you please comment on the "Bacon-Bashline" Process described and adopted in the Department of Insurance Preliminary Prayer?

The allocation methods and the Base Measure for profit used by the Bacon-Bashline Process will more often than not produce confiscatory results. In this Process investment

income is allocated to lines of business by written premium. To illustrate the effects of the Bacon-Bashline investment income allocation methods and Base Measure, consider the example of an insurer who writes only private passenger automobile insurance in California and who earns 6% investment income on surplus after expenses and taxes. The average allowable leverage norms for private passenger auto is 3.1 to 1.

If that California auto insurer wrote no business at all, its return on net worth would be 6%. If it wrote a small amount of auto insurance, say 5% of actual surplus, its return on actual surplus would drop to 0.2% (5% x 15% ÷ 3.1) because the Bacon-Bashline allocation methods would allocate all the investment income to the automobile insurance in California and it would relate all the investment income plus the underwriting income to only 1.6% of the actual surplus (5% ÷ 3.1). The Bacon-Bashline cap on allowable rate of return is 15% of that 1.6% of actual surplus, or 0.2% of actual surplus.

Since investment income alone would produce a rate of return of 375% on that artificial Base measure, the premium projection would need to be reduced and the policyholder dividend projection increased so as to reduce projected income by an aggregate amount of 116% of premium. In effect, the insurer would be forced to give the insurance away and pay a

dividend to policyholders besides in order to comply with the Bacon-Bashline process. I believe that by any standard that would be a confiscatory result.

If the same California auto insurer increased its premium volume to 100% of actual surplus, the Bacon-Bashline Process would place a cap on return on actual surplus of 4.8% (15% ÷ 3.1). Since this is still less than the 6% return that would be produced by investment income on surplus alone, the Bacon-Bashline Process would require the insurer to lose money on its insurance business so that its total return would be less than if it wrote no insurance at all. This would also be a confiscatory result.

If the same insurer increased its premium volume to 310% of actual surplus, the Bacon-Bashline Process would allow a maximum allowable return on actual surplus of 15%. But the potential effects of other aspects of rate regulation unrelated to the profit factor are so large in relation to the capital invested, the risks would probably be excessive in relation to the likely return, and the results could still be confiscatory. In addition, at that level of leverage the insurer would trigger surveillance systems for the regulation of solvency and would have difficulty obtaining a rating of "A" or better from Best's because leverage and profitability, as measured by Best's, would be worse than industry averages.

The "Bacon-Bashline" Process and the definition of "fair rate of return" described in the Preliminary Prayer of the Department of Insurance is an approach that is arbitrary and insupportable because it attempts to allocate surplus by line of business, it encourages reduced capitalization in the property and casualty insurance business by adopting unjustifiably high leverage norms and it attempts to deny companies a reasonable rate of return on all capital actually used in the business. The DOI approach is likely to result in higher, less stable rates for California insurance consumers and subject them to a greater risk of more insolvencies. It also is an approach that is likely to result in the taking of past profits and the taking of extra-territorial profits from insurers who are subject to rate regulation that uses the DOI approach.

46. To the extent that a rollback is ordered, how should the rollback amount be allocated among policyholders?

California Proposition 103 embodies the concept of cost based pricing in its standards of not excessive, not inadequate and not unfairly discriminatory. This is consistent with encouraging a competitive insurance marketplace. If rates are forced to depart materially from

a cost based system by the rollback, competition and availability of coverage may be impaired.

If a rollback of rates is deemed appropriate, the concept of cost based pricing should not be ignored. The rollback amount should be returned to the policyholder group that produced the profits. Therefore, I recommend that the dollar rollback, if any, should be allocated by line in proportion to the profits produced by each line.

EXCERPTS FROM PROPOSITION 103 TESTIMONY

Irene Bass