EXCERPTS FROM PROPOSITION 103 TESTIMONY

(Statement)

J. Robert Hunter

IV. Total Return Ratemaking

A basic principle of the methodologies I propose is that they involve consideration of an insurer's total return on equity or surplus. The reason for this is that such methodologies look at an overall picture of a company. They do not arbitrarily exclude a portion of the insurers' business, although certain items may be excluded to assure efficiency,

prevent over-capitalization, and protect ratepayers from improper expenses. The use of a total return method does not imply that all costs or all revenues must be counted in the formula no matter how unreasonable those costs or revenues are. The utility precedents are clear: they use total return methods and determine what reasonable costs are; include only "used and useful" assets in the rate base; and charge certain expenses "below the line" to stockholders, rather than to ratepayers.

In my opinion, total return methodologies are the only methodologies which provide adequate information for a regulator to review a rate filing under either a prior approval or a rollback system.

The use of total return methodologies is not simply a matter of personal preference; it is also the official position of the NAIC. While the NAIC at one time recommended allowing 5% of premiums in addition to investment income, it now takes the position that neither 5% nor any other arbitrary percentage of premiums is appropriate in the regulation of property/casualty rates. In fact, at 1984 imbedded yields the NAIC concluded that the use of the 5% figure in addition to investment income would result in a total rate of return on net worth after taxes of approximately 25%. This is more fully explained in the "NAIC Study of Investment Income, Supplement to the Proceedings," Vol. II, 1984. I referred to that document in my earlier testimony at the "Tutorial Phase," and I understand that it was admitted into evidence as Intervenors' Exhibit 1.

I strongly commend the NAIC study to the Commissioner. It explains why total return methodologies are not only appropriate, but are superior for rate regulation. Further, the report includes several different total return models. The NAIC adopted the position of the task force which produced the report. While I urge the judge and the Insurance Commissioner to read the whole exhibit, I think a few excerpts explain the NAIC's view.

On page 2, in presenting the task force report, the Chair (Commissioner Daves of Texas) said:

> "The NAIC has never taken the position of favoring either the direct approval process or competitive rating and this report would not change that. The task force has simply worked to assist those regulators, who by law, have the responsibility to make or directly approve rates. For those regulators, the question of competition is a secondary one. How to best perform their statutory duties is the primary question.
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> "The task force has concluded that total return ratemaking methodologies are the most appropriate means by which regulators in direct approval jurisdictions can accomplish their task."

On page 3, the NAIC, while not adopting any specific total return method, did adopt the report and thus, these policy positions:

> Page 4: "For those states which engage in direct approval of rates, the Task Force recommends that the ratemaking/review process include a measure of profitability based upon a total return to equity analysis."
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> Page 9: "While the Task Force has not taken a position on whether or not the direct approval of rates is a desirable form of regulation, it does believe that where this form of regulation is required, [insurance] commissioners generally have the authority to consider investment income. The Task Force concludes that total return ratemaking methodologies are the most appropriate means by which those regulators can accomplish their task."

> Page 12: "Claims that insurers are earning excessive or inadequate profits can not be disproven simply by pointing to the ratemaking process. Because of this, efforts have been made in some states to give investment income explicit consideration in the ratemaking process. These efforts have varied greatly in form, but have generally focused on the 'total return' of insurers. Estimated income from all sources is considered in relation to some investment base (assets or net worth) in determining needed rate levels."

California is now a state where direct regulation is required. I believe, along with the NAIC, that a total return methodology is the most appropriate means for the Commissioner to accomplish her task. In this testimony and in my earlier declaration (which is attached) I have explained the particular methodologies which I recommend.

It is important to note that a common feature of total return methodologies is the setting of a target return. As the NAIC said, (see, e.g., Page 7), a target rate of return is required in any total return ratemaking methodology.

V. Differences Between Rollback Ratemaking and Prior Approval Ratemaking

Although they are quite similar substantively, there are significant differences between the ratemaking methods for rollbacks and prior approval ratemaking.

For total return ratemaking to have any meaning in the prior approval context, it must be applied prospectively because ratemeking is prospective.

In the rollback, however, since some actual data for the rollback period is available, in my view, it would be appropriate to use actual data. The easiest way to assure non-

confiscation, it seems to me, is to use as much of the actual data as is available. This requires some departure from the rollback calculations I proposed in my earlier declaration. This is due to the passage of time. Last July, rollbacks would necessarily have required estimates of certain data. Now, much of those data are at hand. However, while an updated data base is preferable, the methods described in the declaration are still appropriate.

Some of the key differences in method between rollbacks and prior approval relate to the fact that the rollback is a one-time event, now essentially retrospective in application and seeking the maximum constitutionally allowable refund. Prior approval ratemaking, on the other hand, is prospective in nature and seeks to set rates in a range of reasonableness (above the "inadequate" level and below the "excessive" level). The prior approval approach I propose today is flexible and allows the Commissioner to establish a reasonable range of prices for each insurer. However, I believe the rollback method I propose should be strictly applied, because there we are seeking a single number, the maximum allowable rollback.

Thus, while there are ranges of reasonableness for several items in normal ratemaking, it is the edge of <u>each</u> such range that produces the largest rollback which needs to be explored in rollback ratemaking. For example, a selected rate of return on statutory equity (or "surplus" - see below) would be 11.0% for rollback purposes if the trier of fact found an 11% -

15% range was "reasonable," while I would anticipate that a rate producing a return anywhere within that range would be permissible in the prior approval situation. Other examples of the differences between rollback and prior approval methods include:

* If an efficiency standard is adopted relative to expenses, it would be logical in the prior approval phase to allow an insurer which spends less than the standard to "adopt" the standard and thus earn "extra" returns as a result if it so chose. Thus, if an insurer had expenses of 20% of premium and the standard was 30%, that insurer could choose to take the additional 10% of premium as profit or lower rates to gain market share. The 10% of premium translates into 20% of surplus (at 2:1), so the total profit this company could seek, could amount to an addional 20% over the target rate of return. That would certainly create an incentive for companies to increase their efficiency. But in the rollback, the efficiency standard should be viewed as a cap on expenses and, for this one-time rollback, insurers less efficient than the standard would be capped at the efficient insurer level but those more efficient than the standard would have to use their own expense data.

* Similarly, in prior approval ratemaking, I suggest establishing leverage norms under which over-capitalized insurers would not be allowed to earn returns from ratepayers on excess capital but would be allowed to keep all investment yields on such excess capital. More highly leveraged insurers could seek returns based on the norm, thus strengthening the surplus of weaker companies. In the rollback, however, since we are seeking the maximum rollback legally allowed, the leverage norm should be a floor, requiring the use of the norm for over-capitalized insurers but the actual leverage for insurers capitalized at less than the norm.

* In prior approval ratemaking, I suggest the use of the industry-wide imbedded yield plus a 3-5 year average realized capital gain for investment income purposes. Insurers earning above average returns could keep them as additional profits or choose to lower rates as they wished. The risk of higher yield investments would thus fall on the stockholders, not the ratepayers. In rollback, the average should act as a floor with those

earning higher returns required to use those actual returns in determining the degree of rollback. Those earning below average will not be protected against their imprudence in investments.

* For rollbacks, I interpret Calfarm as testing the constitutionality by looking at the return to a whole insurer group, or a whole company where there is no group. If a rollback is required, it should be distributed uniformly to all customers, because the rollback provision of section 1861.01(a) prescribes a rollback of all rates by the same percentage. This may result in some cross-subsidies, although only to the extent they already existed in the insurer's November 8, 1987, rate structure. (If there were no cross-subsidies and each policy contributed equally to the firm's profitability, then a uniform percentage rollback should not create any cross-subsidies.) Thus, Calfarm and Proposition 103 appear to call for the continuation of existing cross-subsidies in the rollback phase. However, in the prior approval phase, it is important not to create cross-subsidies between insurers within a group or between lines within a company, except where they are designed to serve a specific policy objective approved by the Commissioner.

VI. Ratemaking methods - Rollback

I have detailed my proposed rollback ratemaking methodology in the attached declaration. Indeed, I have suggested a set of forms for the calculations of the rollback, although it is the methodologies rather than the forms which contain the substance of my approach. I adopt these methods today. I will briefly describe the highlights of these methods.

A. Provision for Claims

1. Data Base - Loss Development

For the rollback, I suggest using the actual claims data from the rollback period. (For convenience, accident year 1989 could be used as an approximation.) I reject calendar year because of the problem of IBNR (Incurred But Not Reported)

reserves. Even accident year incurred losses can be manipulated by case reserve strengthening or weakening. In order to minimize concern about accuracy of reserves, I suggest developing the incurred loss and incurred loss adjustment expense estimates by using only paid losses and paid allocated loss adjustment expenses as adjusted by paid loss and paid loss adjustment expense development information.

2. Trend

Trend should be applied to the developed incurred loss estimates to bring the incurred losses to the mid-point of the rollback period (May 8, 1989). It is interesting to note that, since Accident Year 1989 will be available before specific rollback hearings are concluded, almost two months of loss, premium, and expense trend backwards in time from July 1, 1989 (the average date of accident of Accident Year 1989) to May 8, 1989, is required.

I propose that the specific annual trends be made a subject of this generic hearing and that trends for claims costs and frequencies (as well as premium and fixed expense trends) be established for all insurers at once. This is because the actual trends are known, the trend period from accident year 1989 to the rollback period is less than two months, and we are not projecting estimates of future conditions. Moreover, trend--which measures only the rate of change of various costs, as opposed to the costs themselves--varies little (if any) from insurer to insurer over a two month period.

Typically, insurers attempt to measure these changes by looking at recent internal data (such as paid claim costs and paid claim frequencies) and at external data (such as CPI, gasoline use and prices, etc.). Given the fact that internal trend data through the middle of 1989 are now available, it should be a relatively easy matter to calculate the actual observed changes.

Trends should be based on the line of best fit as measured by the coefficient of determination. The data should be industry-wide paid claim cost and frequency information for claims trends.

Trend for fixed expenses by line should also be established for all insurers at once, using per-policy actual fixed expense cost movements over the time period. Because fixed expenses are associated with the number of policies, allowing such expenses to change according to premium level changes would be inappropriate. (E.g., The cost of writing the policy does not double when the premium doubles.)

Premium trends should be analyzed on an all-carrier basis as well. Premium trends exist only in some property lines such as homeowners or personal auto physical damage, where "inflation guard" or new and more expensive car purchases give insurers automatic price increases even if rates stay the same.

3. Catastrophe Procedure

Catastrophe procedures similar to those normally used by actuaries should be used in rollback ratemaking. That is, in

coverages where catastrophes occur, such as auto comprehensive or homeowners, the catastrophe losses of any one accident year are excluded and replaced by a loading based on a multi-year, long-term average of catastrophe claims.

4. Credibility of Data

The department should also establish standards for credibility and, equally important, what the complement of the credibility applies to.

Credibility criteria are well established in actuarial theory. "Credibility" simply means the degree to which an actuary believes the data being used to set a price. It is usual to select a credibility formula in which the parameters desired are obtained. For example, one might seek to be within 5% of the "right" answer 95% of the time, or 10% / 90%, or establish another range of believability. The former example requires more data to achieve than the latter. The credibility criterion is determined by reviewing variances in data sets. For low variance, less data is needed to achieve the same believability as for high variance. Some formulas just measure the variance of the number of claims; others the variance of claim cost as well as frequency. The Department should use the latter format, in my opinion, since it is more realistic.[1/]

If it is determined that a body of data are not fully

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1. I suggest the Mayerson, Bowers, Jones approach found in the Proceedings of the Casualty Actuarial Society (see The Credibility of Pure Premium, Mayerson, Bowers, Jones; Proceedings of the Casualty Actuarial Society, Vol. LV, 1968, p. 175).

credible, the question is how to supplement these data to increase the credibility. If an actuary found a set of data to be 10% reliable, what should the compliment (the other 90%) of the credibility be applied to? The current rate? The current rate plus trend? Some other data base?

If the Commissioner finds that a certain company's data are not fully credible, I believe the complement of credibility should be applied to the claims level necessary to achieve the 20% rollback from 1987 rates for the insurer during the rollback review period because this is the statutory rate being tested. Any lack of believability in the data means the burden of proof for a higher price than the statute requires can not be met.

B. Expense Provisions

1. Allocation

Ratemaking for national companies requires a method for allocating certain figures now maintained only on a nationwide basis to California. In the long run, it is preferable that there be a move toward collecting California specific expense information. I encourage the Department to collect it. In the meantime, and of necessity for the rollback, I would suggest the following bases for allocation of expenses to California and to line of business:

Loss Adjustment Expense - by dollars of incurred loss
Commissions and Brokerage - by premium
Taxes, Licenses, and Fees - use actual statutory tax rate for premium tax; allocate by premium for licenses and fees
Other Acquisition - number of exposures or number of policies
General - number of exposures or number of policies.

2. Disallowances

I believe that some items of cost should not be borne by ratepayers, but should be placed "below the line" to be borne by stockholders.

A proposed list of my suggested disallowance items are:

* Political contributions
* Charitable contributions
* Lobbying costs
* Bad faith verdicts and defense costs
* Excessive salaries
* Entertainment
* Institutional advertising
* Transactions with affiliates

The rationale for this list is outlined in my declaration. Several of these items violate actuarial principles in that they are not related to risk transfer. Within this list (or whatever list the Commissioner adopts), I would allow an insurer to show that an item was appropriate (e.g., a transaction with an affiliate was competitively bid).

3. Standards for Efficiency

I further believe an efficiency standard should be adopted for ratemaking which should be set on an all-expenses-combined basis (the sum of commission and brokerage, other acquisition, general and loss adjustment expenses). I suggest setting it to be about halfway between the most efficient, excellent-service-record insurers - who under economic theory really should establish the price in a perfectly competitive market - and the weighted average expense level of all insurers - which average includes some very inefficient providers with poor service records.

I suggest that the Commissioner not adopt a method for establishing the efficiency standard that splits the market in any way, such as according to distribution method. Indeed, in establishing the level of reasonable efficiency, the Commissioner would likely be unfair in establishing different tests for different distribution systems. For example, it would be unfair to require lowering the actual expenses of an excellent service direct writer with overall expense costs of, say, 28% of premium while not doing so for a poor service agency company whose expenses were, say, 38%. Not only that, separate standards fly in the face of the fact that there is only one insurance market, not two or three, serving all of the people of the state. Since some of the best service insurers achieve their high level of service at near the lowest expense ratios, excellence at low cost is an achievable goal.

The formula for setting expenses under the rollback phase should be:

A. Determine the actual expense ratios for each insurer in the line in California (first from California, national only if California is not available).

B. Disallow expenses that should not be borne by ratepayers.

C. Determine the efficient level at half way between the mean of the insurers and the most efficient, good service provider.

D. Allocate national expenses as necessary after disallowances and capping to California.

For rollback purposes, the efficient insurer (lower expenses than standard) must use its own actual expenses to

determine the proper rollback.

Expenses break down into fixed - those that don't vary with premium level - and variable - those, like commissions, that do. The fixed expenses need to be trended. I have not chosen to talk about that in this section, but in the preceding section - provision for claims - the discussion of trend includes expense trend.

C. Profit Provision

1. Target Return

As explained above, I believe that the use of a total return method of establishing the profit provisions is required for rollback ratemaking under Proposition 103 as Calfarm modified it. The first step determining the profit in rollback ratemaking is to determine the minimum needed target profit to meet the Calfarm test of being nonconfiscatory. This requires analysis of returns in the market for businesses of similar risk as the insurers. This can (and should) be determined generically, by line. Since the profit margin is a pre-tax figure, this will have to be adjusted for the actual taxes paid for 1989, if available, or the best estimate of actual taxes reflecting all gains and losses.

2. SAP vs. GAAP

The target rate of return should, I believe, be applied to Statutory Equity ("Surplus") rather than GAAP Equity ("Net Worth") for two fundamental reasons:

(1) The difference between SAP and GAAP Equity has mostly

to do with prepaid agents' commissions. It is a business decision by insurers to prepay commissions, not a legal requirement. The companies could keep the commissions until premiums are earned, thereby giving themselves the chance to invest the funds, or exclude the prepaid commissions from the ratebase. Use of GAAP would increase the ratebase but not increase the investment income, since it would be in the hands of the agents. Insurers should not be allowed to obtain a return on funds they have voluntarily paid out unless they also impute to the benefit of ratepayers the voluntarily surrendered investment income.

(2) Since insurers consistently claim that their statutory reserves are understated, statutory surplus must, by definition, be overstated. To further inflate these figures by amounts disallowed by SAP is inappropriate in my view.

3. Allocation

A question in the context of Statutory Equity is how to allocate it to state, company, and line of insurance, if need be. I believe that the preferred method is to use reserves for such an allocation because it is fundamentally the estimates of future loss potential that surplus backs up.

Some have argued in this proceeding that surplus can not be allocated, and that all surplus is available for any claim. This is not really accurate - and is irrelevant in any case. Insurers are regulated as to how much surplus can be exposed to any one risk. For example, the California Department

of Insurance monitors insurers against a standard of no more than 10% of surplus exposed to any one earthquake (assuming a magnitude of 8.25 on the Richter Scale). Further, mechanisms exist to protect against huge surplus drain by loss ratio reinsurance or other reinsurance arrangements. Loss ratio reinsurance protects a primary insurer from having losses more than some fixed percentage of premium.

4. Leverage Norms

I further believe that there is need to establish a normative premium to statutory equity (surplus) ratio (or a normative premium to GAAP equity ratio if that is decided to be used).

The industry average premium to surplus ratio is about 2:1. Some insurers are much below that; others exceed it. During the earlier specific hearings, an insurer witness suggested a 2.5 to 1 overall standard might be acceptable. I believe a 2.0 to 2.5 to 1 overall standard is appropriate, which should vary by line of business. In the rollback phase the normative ratio acts as a floor, since higher than average actual ratios must be used to determine if the Proposition 103 rollback can be achieved without a confiscatory result.

5. Determining The Underwriting Margin

The appropriate method of getting the needed profit margin from the post-tax target return on surplus is straightforward. The target return is first converted to a pre-tax basis by using the actual industry wide tax paid in the most

recent year. The investment income on surplus, using industry imbeded yields and 3-5 year average realized capital gains, is deducted. The result is the operating return on surplus. Dividing this by the leverage norm gives a target operating profit margin on sales (premium). The underwriting margin is determined by deducting imbedded investment income (including 3-5 year average realized capital gains) on reserves and deducting miscellaneous income, such as that derived from premium financing. If the investment income is greater than the target return, which is typical for long-tailed lines, the underwriting margin needed for establishing proper rates will, of necessity, be negative.

Another key question is how to allocate investment income to state and to each line of insurance. I believe that allocation based on reserves is appropriate.

The forms attached to my declaration detail the method I propose. The method tests the maximum rollback possible short of confiscation, consistent with the intent of Proposition 103 and the California Supreme Court in Calfarm.

VII. Ratemaking Method - Prior Approval

The method I propose for the Department to use as the Commissioner's test under prior approval allows for returns above the confiscatory level, often considerably above it. It would enable the Commissioner to be sure that rates for reasonably efficient insurers fall in the allowable range between inadequate and excessive, and allows significantly more profit opportunities

than the rollback method permits for efficient providers. This method is similar to that suggested for the rollback. While it is not required for use by insurers, the data needed to undertake the review, including certain calculations, should be made a required part of every filing for rate changes. It is wise, I think, to promulgate the methods, after hearing, so that insurers and consumer groups alike know where the Commissioner's range of reasonableness is and what she would likely approve. This is not to say she should in any way restrict new and innovative ideas of either filing insurers or intervening consumers, nor be restricted herself in any specific filing.

A. Provisions for Claims

The method I propose as the Commissioner's test of an insurer's anticipated claims provision in rates is similar to the rollback methods, but much more flexible.

1. Data Base - Loss Development

The Commissioner should establish, as part of the credibility criteria, a data base that indicates when she feels an insurer is large enough to use only the latest accident year of experience for setting rates, when two years are required, and when three years are required. The Commissioner should require loss development information to be provided on both an incurred and paid basis so that tests of reserve changes can be accomplished. Incurred loss development should be allowed except when paid loss development indicates a significant reserving change. Loss development data for all companies should be

collected and disseminated by the Commissioner to assist small insurers and the public.

2. Trend

Trend factors for losses, expenses, and premiums should be the subject of competition, particularly as they relate to projections into the future for inflation rates, accident rates, etc. Trend data for all carriers should be collected and disseminated by the Commissioner, including a generic annual analysis of these trends and the range of reason she will apply to the trends by line of insurance based upon her generic review.

3. Catastrophe

The same procedure for catastrophic claims outlined under rollback applied to prior approval.

4. Credibility

The Commissioner should aid smaller insurers by collecting historic data on loss costs and frequencies from all insurers (as part of the classified data I suggested in my November 16, 1989, testimony on section 1861.02). Once available, the complement of the credibility might then be applied to the loss expectations for that group of insurers reporting data to the Commissioner.

B. Expense Provision

1. Allocation

The same allocation procedures set forth above for rollback should be employed for prior approval.

2. Disallowances

As during the rollback phase, a disallowance and capping process should be part of the Commissioner's test of expenses for prior approval.

3. Standards For Efficiency

Unlike rollback, the capped expense level should not be used only as a ceiling, but should be available for adoption by efficient insurers if they chose to do so. In other words, insurers which operate more efficiently than the standard can keep their efficiency margin as additional profit by adopting the standard, or can use their lower costs to lower rates to compete more vigorously in the market as their management sees fit.

C. Underwriting Profit Provision

1. Target Return

Under prior approval ratemaking, total return ratemaking is required if investment income is to be fully reflected mathematically in ratemaking. The underwriting profit provision must produce, along with all investment income, a reasonable opportunity to achieve the target range of overall return on surplus selected for the line based on generic hearings. Since imbedded investment yields and 3-5 year average capital gains should be included in rates on an industry-wide basis, and leverage norms are to be employed, the target range can be converted into an operating profit target if that is desired. The steps to do this are set forth in the rollback discussion above.

2. SAP vs. GAAP

For the reasons outlined above, I believe that statutory equity (surplus) should be the rate base for prior approval ratemaking.

3. Leverage Norms

Unlike during the rollback, companies willing to take higher risks (such as by earning higher investment income than average or using a higher leverage ratio) could obtain greater rewards which would not have to be passed back to ratepayers. This will give additional retained earnings to higher risk enterprises which should lower their leverage as these added earnings are retained, assuming prudent management decisions and subject to Department of Insurance solvency review. Companies with low leverage (over-capitalization) or low investment returns could file on that basis, but would face close scrutiny of their rate filings.

4. Determining The Profit Margin For Rates

The same methods as described under the rollback section apply for prior approval ratemaking.

VIII. **The Role of Competition in the Prior Approval Phase**

Proposition 103 is clear that competition is secondary to prior approval. It states bluntly that "In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition..." (emphasis added) Yet, Proposition 103 also expresses a purpose of encouraging competition. Indeed, Proposition 103 repeals the state antitrust exemption, repeals

the anti-rebate law, repeals the anti-group law and repeals prohibitions on bank entry into the insurance business. For automobile insurance, one of the main concerns of Proposition 103, the Commissioner is arranging to produce computerized price information. In addition, good drivers, as defined by the Act, have the right to get the insurance the state requires them to buy from the company of their choice, thus bringing supply and demand into a more balanced position.

The methods I propose today will meet Proposition 103's purposes of providing an accountable prior approval system but the methods will also allow competition to have significant impact on an individual insurer's pricing decisions. Competition will keep prices down for efficient insurers who could, for example, earn 20% above the cost of capital. Presumably, efficient insurers will compete in zones of reason between excessive and inadequate. In other words, competition remains a fundamental building block in the system of prior approval ratemaking I am suggesting to the Commissioner.

IX. Conclusion

The method I propose for the rollback phase follows both Proposition 103's rollback intent and the Calfarm decision, which calls for rates that are rolled back to the greater of the Proposition 103 rollback ~~lines~~ limit or just above the confiscatory level for a reasonably efficient insurer.

The method I propose for the ongoing prior approval phase is a test of the range of reasonable returns for a

reasonably efficient insurer. It allows extra profit, well over the cost of capital, for insurers which are more efficient in expense levels, capitalization, or investment than the standard established by the Department for an efficient insurer.

Adoption of these proposals will assure California consumers that their rates will fully meet the rollback and prior approval requirements of Proposition 103 and will also assure reasonably efficient insurers significant profit opportunities. Finally, these methods adopt real incentives for the less efficient insurers to improve their performance and to compete more intensely in achieving excellent service at a reasonable price.