INSURANCE
DEPARTMENT OF BANKING AND INSURANCE
DIVISION OF INSURANCE

Rate Filing Requirements: Voluntary Market Private Passenger Automobile Insurance

Adopted Amendments: N.J.A.C. 11:3-16.2, 16.3, 16.8, 16.9, 16.10 and 11:3-16 Appendix Exhibits A and H.

Proposed: July 21, 2003 at 35 N.J.R. 3084(a)

Adopted: November 19, 2003 by Holly C. Bakke, Commissioner, Department of Banking and Insurance

Filed: November 19, 2003 as R. 2003 d.499, **with substantive changes** not requiring additional public notice and comment (see N.J.A.C. 1:30-6.3).

Authority: N.J.S.A. 17:1-8.1 and 17:29A-1 et seq.

Effective Date: December 15, 2003.

Expiration Date: January 4, 2006.

Summary of Public Comments and Agency Responses:

The Department of Banking and Insurance (Department) received written comments from the following: Allstate New Jersey Insurance Company, Alliance of American Insurers, New Jersey Manufacturers Insurance Group, State Farm Indemnity Company, the Independent Insurance Agents of New Jersey, National Association of Independent Insurers, the Professional Insurance Agents of New Jersey, and one comment submitted jointly by the Insurance Council of New Jersey and the American Insurance Association.

COMMENT: One commenter questioned the appropriateness of eliminating the UCJF expense for ratemaking, since no methodology for dealing with non-excess medical benefit UCJF costs has been proposed. The commenter stated that if treating these expenses as a policyholder assessment is authorized, then elimination of the UCJF is appropriate. Two commenters objected to the Department's deletion of the reference to the Unsatisfied Claim and Judgment Fund (UCJF) in the definition of expenses found at N.J.A.C. 11:3-16.2. The commenters recommended amending the definition as follows (additions in boldface):

"Expenses" means that portion of a rate that is attributable to commissions and brokerage, other acquisition expenses, general expenses, and taxes, licenses and fees and assessments for Unsatisfied Claim and Judgment Fund ("UCJF") losses and costs relating to pedestrian personal injury protection assessed against insurers. Expenses do not include Automobile Insurance Risk Exchange ("AIRE").

"UCJF' means the Unsatisfied Claim and Judgment Fund, established pursuant to N.J.S.A. 39:6.61 et seq.

RESPONSE: The Department agrees with the commenter. P.L. 2003, c. 89, effective June 9, 2003 transferred the operations and responsibilities of the UCJF to the Property Liability Insurance Guaranty Association (PLIGA). Pursuant to N.J.S.A. 39:6-86.1 and section 35 of P.L. 2003, c. 89, the UCJF is now responsible for providing pedestrian PIP benefits. Pursuant to Sections 2 and 3 of P.L. 2003, c. 89, PLIGA is also authorized to manage, administer, and pay claims against the UCJF and the JUA/MTF. These include claims by victims of accidents involving unidentified or uninsured motorists. On that basis, the Department proposed to delete the reference to the UCJF from this definition since, as amended by P.L. 2003, c.89, Section 66, N.J.S.A. 17:30A-16 provides that assessments imposed on insurers by the PLIGA pursuant to N.J.S.A. 17:30A-8 may be recouped by them through surcharges upon insureds.

As amended by P.L. 2003, c. 89, section 4, N.J.S.A. 17:30A-8 now provides PLIGA with the authority to assess member insurers for excess medical benefits (EMB) However, as amended, N.J.S.A. 17:30-8 and 17:30-16 only explicitly authorize PLIGA member insurers to recoup these EMB assessments through surcharges upon insureds. They do not authorize the recoupment of the assessments made by the UCJF related to pedestrian PIP and uninsured motorist coverages through surcharges upon insureds. Thus, the Legislature contemplated that these assessments would be a factor that would be included in insurers' rate calculations. Continuing to treat these assessments as an expense will enable them to be loaded into rates on an equitable basis. As a result of the enactment of P.L. 2003, c.89, PLIGA is now responsible for the imposition and collection of the assessments to be made upon auto insurers with respect to uninsured motorist coverage and pedestrian PIP benefits payments. Based upon the foregoing, those assessments, although made by PLIGA, should properly continue to be considered by insurers as expenses when calculating rates. Consequently, the Department is amending the definition of expenses upon adoption to render it consistent with the applicable law and to clarify that it includes the uninsured motorist and pedestrian PIP-related assessments which, again, insurers lack the statutory authority to recoup through surcharges upon insureds.

COMMENT: Two commenters expressed concern with N.J.A.C. 11:3-16.8(f)1. The commenters stated that insurers are required to show physical damage loss trend data either on the basis of the $500.00 deductibles or on the basis of all deductibles combined adjusted to the $500.00 deductible basis. The commenters believe that both of these methods will introduce significant inaccuracies. The commenters suggested that insurers be given the option of providing physical damage loss trend data on the basis of the respective insurer's in-force deductibles. The commenters recommended the following changes to N.J.A.C. 11:3-16.8(f)1 (additions in boldface; deletions in brackets):

> 1. All internal loss trend data on a paid and, at the filer's option, incurred basis shown separately for frequency and severity for the latest available five rolling years on a quarterly year ending basis for all coverages for New Jersey. Bodily injury liability and property damage liability trend data shall be given at the same limits as used for (a) above. [Basic personal injury protection ("PIP") data shall be given at a per person limit retained by the insurer according to N.J.S.A. 39:6-73.1 ($75,000 of insurer payments)]. Physical damage coverages shall be shown on the basis of the $500.00 deductible, on the basis of in-force deductibles**,** or all deductibles combined adjusted to the $500.00 deductible basis. In the [latter] case of all deductibles combined adjusted to the $500.00 deductible basis, the filer shall provide an explanation of the methodology for adjusting other than $500.00 deductible data to the $500.00 deductible level.

RESPONSE: The Department disagrees with the comment and believes the current methodology is appropriate because its methodology permits the data to be viewed on a more common basis. Insurers may include the data referenced in the comment, in addition to the requirements as stated, as part of an alternate ratemaking methodology.

COMMENT: One commenter stated that, with respect to N.J.A.C. 11:3-16.8 (physical damage trend) it might be appropriate to adjust trend data to a $750.00 deductible basis if this is to become the default deductible and eventually may become the most common deductible option.

RESPONSE: Not all companies have made the $750.00 deductible the base option, which is distinct from the default option. The Department is not proposing to make this change at this time; however, it will consider doing so if the $750.00 deductible becomes more common.

COMMENT: Several commenters expressed their objection to N.J.A.C. 11:3-16.10(a)1. One commenter stated that the return on equity (ROE) should be the lower of 12 percent or the insurer's own standard, and should be translated into a percent of premium using the greater of the insurer's premium to surplus calculation or 2 to 1. The commenter stated that there are no exceptions to the rules.

The commenters contend that the proposed calculation of the "profit and contingency provision" is inconsistent with the requirements of Section 68 of P.L. 2003, c. 89. The commenters stated that this section specifically altered the determination of the allowance for profit and contingencies and provides that it is "calculated by multiplying the premiums earned by the profit and contingency factors authorized for use with the insurer's approved rate filings, which profit and contingency factors shall be based on the insurer's targeted rate of return, method of doing business, the cost of capital and other relevant economic considerations of the insurer." The commenter stated that a regulation that seeks to define a maximum allowable rate of return applicable to all insurers cannot be "based on the insurer's targeted rate of return, method of doing business, the cost of capital and other relevant economic considerations of the insurer." The commenter contends that Section 68 requires the determination to be insurer specific. The commenter stated that individual insurers are constitutionally entitled to a fair rate of return. It may be reasonable for the Commissioner to establish a "presumptively reasonable" target rate of return, but each insurer must be permitted to file for approval of its specific target rate of return based on the Section 68 factors. Thus, a carrier that needs a higher return on equity to rebuild surplus after losses (it may have a premium to surplus ratio of worse than 3 to 1) will be able to obtain it.

Another commenter stated that the only economically reasonable approach is to allow companies to base rates on their actual premium to surplus ratio or, at the companies' election, an assumed ratio of 2 to 1. The commenter stated that to the extent the proposed amendments reflect a concern that less leveraged companies will obtain higher insurance rates, the commenter stated that the concern is unfounded. The commenter stated that a competitive market will prevent excessive rates.

The commenter suggested that the two caps should be eliminated entirely. The commenter contends that the prior approval authority of the Department is such that the Department can disapprove a filing that contains an excessive return on equity. The commenter stated that if the Department is inclined to keep the ROE cap, then carriers should be allowed to file for an exception that the Department will review on a case-by-case basis.

One commenter noted that, historically, the property and casualty industry has had an ROE below 12 percent. The commenter contends that this may not be true for individual insurers. The commenter recommended that this cap be removed, since a ROE above that level seems to be the exception rather than the norm.

RESPONSE: The Department disagrees with the commenter's suggestion to eliminate the cap entirely; to do so would abdicate the statutory requirement for a standard ratemaking methodology and engender unnecessary rate changes based simply on the change in methodology. The shift from the Clifford formula provision of 3.5 percent of premium to a proposed 12 percent maximum ROE should accommodate the interests of both insurers and consumers, without placing undue burdens on either party. In setting the maximum ROE at 12 percent, the Department considered the level of interest rates and the rate of return for the property casualty industry. The Department notes that 10.73 percent is the average rate of return for insurers in the property and casualty industry. The 12 percent maximum ROE also reflects an attempt to strive for rate adequacy, while preventing undue market disruption. The assertion that a competitive market will by itself prevent excessive rates is premature, considering current market conditions.

The Department's proposed 12 percent maximum ROE provides a reasonable profit and contingency factor at present, considering current interest rate levels and the ROE for both insurers and other industries. Many insurers may, in fact, presently have a target ROE that is lower, and the 12 percent allowable maximum. Futhermore, the rule permits the maximum ROE level to be increased, dependent on economic conditions. Finally, if an individual insurer wants the Department to consider its own targeted rate of return and other economic concerns, these rules continue to provide that an alternative ratemaking methodology may be included along with the standard ratemaking methodology filing. Upon approval, rates based on the alternate methodology may be used. Thereafter, an approved alternate ratemaking methodology may also be used for the purpose of limited rate changes and excess profits calculations. As a more competitive market evolves, alternate methodologies are expected to become more common.

COMMENT: Several commenters expressed a different concern with N.J.A.C. 11:3-16.10(a)1, which states that the calculation of the underwriting profit and contingency provision shall be calculated in accordance with the ROE and shall be limited to a maximum of 12 percent.

The commenters also questioned the calculation involving the ROE. For example, the proposed amendments provide that the calculation of profit and contingency provision using the ROE formula shall be based on the cash flow method or another method provided. However, neither the cash flow nor another method's formula is provided to insurers in the proposed regulation. The commenter also noted that the proposal does not specify if the 12 percent ROE is calculated using private passenger auto data only, or if all lines are to be included.

The commenter stated that the specific methodology used by the Department to fix 12 percent as the maximum allowable profit is not clearly explained. While there are references to certain factors to be considered such as interest rate levels, average insurer and other industry ROE levels, and the level of auto insurance market competition in New Jersey, the way in which this information will be obtained and analyzed to make the maximum ROE determination is not provided. The commenter stated that there is no indication on how the factors would be measured in an evaluation to change it.

The commenter suggested that the rules allow an insurer to provide company data and/or other specific circumstances to the Department to justify a higher ROE than 12 percent for that particular company. The Department could grant authorization for the company to have a higher ROE than 12 percent if justified by the information provided by the particular insurer.

The commenters also expressed concern with other aspects of N.J.A.C. 11:3-16.10(a)10. Two commenters stated that the inclusion of "such other occurrences or conditions that may impact upon the adequacy of the ROE" in N.J.A.C. 11:3-16.10(a)1i is too vague to withstand constitutional challenge. The commenters contend that it is also unclear what the value or utility is of including "the level of competition in the New Jersey auto insurance market." The commenters believe that a reasonable rate of return is based on broad economic market indicators that are reflective of a competitive market. If there is a high level of competition in New Jersey, it will inherently drive the rate of return down. If there is a low level of competition, which could have the tendency to raise rates of return, reliance on independent market indicators that reflect a competitive market would produce an appropriate rate of return and would inherently compensate for any asserted lack of competition. In either case, reliance on independent economic indicators eliminates any perceived need for an implied adjustment to reflect competition in New Jersey.

Additionally, the commenters stated that the requirement of using the lower of 2 to 1, or the actual premium to surplus ratio may endanger companies that are operating at a higher premium to surplus ratio. Such insurers are inherently more risky and it is therefore reasonable to expect that investors would expect a higher rate of return. Investors inclined towards investments at that risk level will demand a higher rate of return. The commenters contend that the proposal discourages investment in more highly leveraged companies and diminishes the ability of companies to grow.

The commenters recommended the following amendments to this provision (additions in boldface; deletions in brackets).

"The calculation of the underwriting profit and contingency provision, taking into account investment income on loss reserves, loss adjustment expense reserves, unearned premium reserves and policyholder surplus shall be calculated in accordance with the Return-On-Equity (ROE) methodology, wherein until revised pursuant to the procedure set forth in (a) 10 below, the target after-tax ROE shall be limited to a maximum of 12.0 percent as a ratio to surplus or the company's target ROE, inclusive of projected investment income on loss reserves, loss adjustment expense reserves, unearned premium reserves and policyholder surplus. <u>A company may file in excess of 12.0 percent if it can demonstrate need based on the insurer's targeted rate of return, method of doing business, the cost of capital and other relevant economic considerations of the insurer.</u> The premium-to-surplus ratio (P/S) used for this calculation shall be the company's actual P/S as of the end of the latest calendar year[, whichever is greater]. The ROE calculation shall reflect investment income earned on surplus, based on past rates of return calculated in (a) 8 below, to derive a net return on policyholder funds. The target return on policyholder funds shall be converted to a percentage of earned premium. Investment income earned on policyholder funds shall be calculated using a discounted cash-flow method with the cash-flow patterns provided in N.J.A.C. 11:3-16.9(c); otherwise the company shall provide the information contained in (a)2 through 6 below. The allowance for profit and contingencies used in deriving the expected loss and loss adjustment expense ratio shall be net of all investment income in policyholder funds and surplus, stated as a percent of earned premium and converted to a pre-tax basis.

> i. Factors the Department will consider in <u>approving an insurer's target ROE</u> shall include <u>the insurer's method of doing business, the cost of capital and other relevant economic considerations of the insurer which may include</u> interest rate levels, nationwide insurer return on equity levels, ROE levels in other industries, as reflected in AM Best Reports, NAIC profitability reports, return on surplus, the Federal prime interest rate, and other <u>publicly available independent indices</u> of similar reliability."

RESPONSE: As noted in the Response to the previous comment, the Department agrees with the assertion that the property casualty industry has historically had ROEs that are below 12 percent, and that the proposed amendments set a maximum ROE for the new standard methodology. The 12 percent maximum should accommodate a wide spectrum of the various companies' business methodologies, loss of capital, etc. Nevertheless, the Department believes the shift from the Clifford Formula, with a target of 3.5 percent of premiums, to the ROE method with a maximum target of 12 percent and P/S ratio of 2:1

in determining the "profit and contingencies" provision, is a reasonable approach, whereby the interests of both consumers and insurers are considered. Under the Clifford Formula method, the after-tax target of 3.5 percent of premium is offset by investment income (from policyholder-supplied funds) to obtain the allowance for "profit and contingencies," on an after-tax basis. The latter is then converted to a before-tax basis, by removing the effect due to Federal Income Tax (currently at 35 percent). Additionally, the determination of the investment income (from policyholder-supplied funds) is as outlined in N.J.A.C. 11:3-16.10.

The calculation of the allowable "underwriting and profit contingencies" via the ROE method is similar to the determination under the Clifford formula, except that the ROE determination should reflect an after-tax investment income based upon GAAP (generally accepted accounting principles) Equity or Surplus, based on past rates of return calculated as in N.J.A.C. 11:3-16(a)8. That is, the selected after-tax ROE target (with a 12 percent maximum) is initially offset by the after-tax "investment income on Surplus or GAAP Equity" to derive the after-tax "required return on policyholder funds (which is expressed as a percentage of Surplus)." The latter is then converted to a premium-basis, or the after-tax "required return on policyholder funds (expressed as a percentage of Premium)" by dividing by the premium-to surplus ratio, which is limited to a minimum of 2:1. The resulting percentage is then offset by the investment income (from policyholder-supplied funds, as outlined in N.J.A.C. 11:3-16.10) to obtain the after-tax "Underwriting Profit and Contingency." Finally, the latter is converted to a pre-tax basis, by removing the effect due to the Federal Income Tax (currently stated as 35 percent).

Alternatively, the "Underwriting Profit and Contingency" can be obtained by using iteration, via a cash flow procedure, to achieve an overall ROE target that is limited to 12 percent (after-tax). Here again, the cash flow layout is similar to that used under the Clifford Formula, except that additional elements or factors, as stated earlier on, need to be reflected in the cash flow calculation.

The rules do provide for insurers to provide company-specific data and circumstances in support of an alternate methodology to justify a ROE of more than 12 percent for a particular company.

Thus, an insurer may include an alternate ratemaking methodology in its filing to address its own unique circumstances, such as usual costs of capital or to retain its capital structure in light of its actual premium to surplus ratio.

Finally, the Department believes that the factors and information sources delineated in N.J.A.C. 11:3-16.10(a)1i as proposed as proposed, which the Department considers in adjusting the maximum ROE, provided sufficient guidance to enable the industry to gauge when and how much of any adjustment is necessary. Nevertheless, in an effort to supply as much detailed information as practical, the Department has incorporated the last commenter's suggested change to N.J.A.C. 11:3-16.10(a)1.i.

COMMENT: One commenter stated that the amendments to N.J.A.C. 11:3-16.10(a) provide that investment income will include income from policyholder surplus. The commenter contends that this surplus belongs to the shareholders in a stock company and to the policyholders in a mutual company. The commenter stated that the surplus is essentially the protection insurers have against large unexpected liability from any line of business. The commenter stated that the Department's amendments would inappropriately utilize the policyholder's surplus for calculation of the premium-to-surplus ratio. The commenter recommended that the provision be amended to eliminate the use of investment income earned on surplus in the ROE calculation.

RESPONSE: The Department disagrees with the commenter. As alluded to by the commenter, the surplus is essentially the protection insurers have against large unexpected liability or any contingencies. The issue here is not with the surplus, but with the income generated therefrom. The Department believes that any generated investment income needs to be considered in determining a reasonable "underwriting profit and contingency" when using the ROE method. Not accounting for such income would require a higher than reasonable provision for "underwriting profit and contingency" with consumers contributing more (through increased rates) towards protection against such contingencies.

Although filers shall file using the Department's methodology, N.J.A.C. 11:3-16.10(f) permits a filer to submit an alternate ratemaking methodology or use different data to support its provision for "underwriting profit and contingency," provided that it is clearly labeled as such and is submitted in addition to the Department's methodology.

COMMENT: One commenter suggested that the Department amend N.J.A.C. 11:3-16.10(a)10. The commenter objected to the first sentence of proposed N.J.A.C. 11:3-16.10(a)10, which states that "…the Commissioner may issue an Order, no less frequently than once every two years, to adjust the maximum allowable ROE." The commenter stated that the word "may" means that the Commissioner could decline to issue an Order for any number of years. The commenter contends that the intent appears to be that the Commissioner is to update the maximum ROE at least every two years, to avoid the problem of having an outdated ROE (Clifford Formula numbers were kept for about 30 years without change), and the language needs to match the intent.

Therefore, the commenter suggested that N.J.A.C. 11:3-16.10(a)10 should be amended to read (additions in boldface):

"In accordance with (a)1 above, the Commissioner shall issue an Order, no less frequently than once every two years, to adjust the maximum allowable ROE."

RESPONSE: The Department disagrees that an adjustment in the maximum ROE should be mandatory every two years, regardless of whether conditions have changed. As noted above, the 12 percent maximum should, at this time, provide for rates that yield a reasonable rate of return for a wide spectrum of companies. As a more competitive market evolves, mandatory changes in the maximum ROE could, in fact, constrain and reverse progress toward a competitive market.

COMMENT: One commenter noted that N.JA.C. 11:3-16.10(a)10 provides that the Commissioner shall publish a notice in the New Jersey Register prior to issuing an Order adjusting the maximum allowable ROE. The commenter believes that this should include the preliminary ROE figure for everyone to comment on.

The commenter stated that the notice should include a preliminary ROE figure, any computations used for that figure, along with the factors that the Commissioner will be reviewing. The commenter believes that the industry and the public should be allowed to comment on the preliminary number and any preliminary computations made by the

Department. The commenter suggested that N.J.A.C. 11:3-16.10(a)10 be amended to read (additions in boldface):

> "The notice shall identify those factors, as set forth in (a) above, which the Commissioner intends to consider when conducting his analysis, a preliminary ROE figure and any computations used to determine that preliminary figure."

Other commenters recommended that the Commissioner be granted the authority to approve different ROEs based on the economic criteria on an individual company basis instead.

RESPONSE: The Department agrees with the commenter that the notice provided in N.J.A.C. 11:3-16.10(a)10 should be amended to provide an indication of the magnitude and direction of the anticipated change. A specific ROE percentage, with all attendant calculations, would, however, be too confusing and not permit meaningful public input. Therefore, the Department is amending this provision on adoption as follows (additions in boldface):

> "The notice shall identify those factors, as set forth in (a) above, which the Commissioner intends to consider when conducting his analysis, a preliminary range for the change in ROE and the factors used to determine that range."

With respect to the authority to approve a different ROE on an individual company basis, the Department again notes that 12 percent is the maximum, and insurers needing a higher ROE may submit an alternate rate making methodology.

COMMENT: Two commenters expressed concern with N.J.A.C. 11:3-16-10(b)10, and requested that the rule be amended to provide that the adjustments to the maximum allowable ROE be done by rule rather than an order.

The commenter suggested amending N.J.A.C. 11:3-16.10(a)2i as follows (additions in boldface):

"Factors the Department will consider in approving an insurer's target ROE or in determining future adjustments to the maximum ROE permitted shall include the insurer's method of doing business, the cost of capital and other relevant economic considerations of the insurer which shall include interest rate levels, nationwide insurer return on equity levels, ROE levels in other industries, as reflected in AM Best Reports, NAIC profitability reports, return on surplus, the Federal prime interest rate, and other publicly available independent indices of similar reliability.

The Commissioner of Banking and Insurance shall promulgate rules and regulations concerning any adjustments to the maximum allowable ROE."

RESPONSE: The Department disagrees with the commenter that an individual insurer's target ROE should be considered, because the rule establishes a maximum ROE that accommodates a wide spectrum of companies with different individual needs. Nevertheless, for future adjustments to the maximum ROE (if need be), the Department agrees with the commenter that revising the rule to refer to other "publicly available independent" indices of similar reliability is a worthwhile clarification.

The Department disagrees, however, that any change to the maximum ROE should be done by rule. Requiring that such change be made through the rulemaking process overlooks the potential need to act promptly during times of rapidly changing economic conditions. A proposed rule, after being drafted, generally takes about six months to become effective, and would involve a longer time frame if the initial proposed ROE figure had to be re-proposed based on comments or data received.

As amended, N.J.A.C. 11:3-16.10 contains sufficient criteria regarding the factors and publicly available sources of information that the Commissioner will consider in adjusting the maximum ROE, as well as a notice and an opportunity to comment on the proposed change.

COMMENT: Several commenters requested clarification on Exhibit A, the annual T statistics that are required for all loss trend data. Specifically, the commenters requested that the Department provide a detailed example showing how these statistics are to be calculated.

RESPONSE: The rules concerning the annual T statistics are not changing, and insurers should calculate them as they have in the past.

COMMENT: Several commenters expressed concern with Exhibit H, which places a cap on the expenses for acquisition and general expenses that an insurer can file. The commenters stated that the cap is the weighted average of the 20 largest auto insurance groups that have the same market method.

The commenters stated that, in practice, a formulaic cap penalizes insurers in unique circumstances, including insurers that spend more to provide superior service. The commenters believe that if insurers can demonstrate that they provide superior service, or otherwise can justify higher expenses, they should be permitted to recognize their actual expenses, even if they exceed the cap. The commenter stated that consumers can make the choice between higher rates and better service or lower rates and worse service. The commenters suggested that the expense cap and Exhibit H should be deleted entirely.

Another commenter suggested that companies be allowed to use their actual expenses in their rate filing. The commenter stated that this would provide a more fair and accurate representation upon which rate making calculations could be based.

RESPONSE: The current provision was intended to implement N.J.S.A. 17:29A-36.2(3), which requires that the Department's standard ratemaking methodology provide "standards of efficiency, …based upon industry-wide aggregate averages and other relevant data and factors…,"; because the Department did not propose substantive changes to this Exhibit, any substantial change to this regulation would be beyond the scope of this proposal. The Department recognizes, however, the importance of not having insureds subsidize insurer inefficiencies, which outweighs the possibility of insureds not getting the benefit of increased service levels for a higher cost. The Department notes that it will be proposing amendments to the expense capping provision regarding membership/non-membership companies in the near future.

COMMENT: One commenter stated that they believe that the ROE calculation method works as follows. The proposed standard premium to surplus ratio is 2 to 1. The commenter believes that a company is entitled to earn up to 12 percent profit on the surplus supporting private passenger automobile premium writings on New Jersey policies at a 2 to 1 ratio. However, any investment income on surplus in excess of the two to one ratio is not considered in the ROE calculation method and does not count against the allowable 12 percent profit on the amount of surplus derived from the premium to surplus limitation imposed on well-capitalized companies.

The commenter stated that an interpretation different from that set forth above would penalize well-capitalized companies, with devastating market implications. Such an interpretation would create an absolute disincentive for companies to maintain capital in excess of the 2 to 1 ratio. Out-of-State companies would likely transfer capital out of New Jersey subsidiaries to maximize their opportunity for a reasonable return on equity. Such a result would not be good for consumers, as less surplus would be available to support the needs of existing policyholders and new business growth. Nor is it consistent with stated goals of encouraging companies to invest in New Jersey.

The commenter stated that the Department must clarify its interpretation so as to encourage companies to maintain more surplus than the 2 to 1 ratio in order to be able to weather all sorts of storms both political and weather related. The commenter believes that companies should not be required to include investment income on additional surplus that is in excess of the 2 to 1 ratio for the reasons stated above.

The commenters also noted that the Department's rules seek to limit the ROE to surplus representing one-half of net written premium. They contend that, consequently, the regulations would deprive insurers with lower premium to surplus ratios of the opportunity to earn a fair return on all surplus – an opportunity, not a guarantee. The commenters believe that this limitation penalizes well-capitalized companies that provide a high level of financial protection for their policyholders by seeking to prevent them from obtaining an adequate rate of return on any surplus beyond the 2 to 1 ratio. The commenter stated that this proposal severely discourages investment in New Jersey. Rather than keeping capital in New Jersey to support growth, this regulation would encourage capital over the "allowed" surplus to be invested where there is an opportunity to earn an adequate rate of return. The commenters contend that this is not mitigated by the excess profits provision allowing for a "credit" for reinvestment in the New Jersey market. The commenter stated that the issue is an adequate targeted rate of return at the outset. If an insurer is deprived of the opportunity to earn an adequate rate of return in the ratemaking process, the issue of an "excessive profit" will not arise and the matter of a credit for reinvestment is illusory.

RESPONSE: The Department disagrees with the comments. If the investment income (on the additional surplus that is in excess of the 2 to 1 ratio) constitutes income generated from a company's GAAP equity or surplus, then such income should be included in the "underwriting profit & contingency" calculation, using the standard ROE ratemaking methodology. Additionally, when using that methodology, such income counts towards the overall ROE target of 12 percent. The Department believes that the change in "underwriting profit & contingency" calculation from the Clifford formula to the ROE method, and the imposition of a minimum of 2 to 1 leverage ratio, are positive decisions for both companies and consumers. The change to ROE method is consistent with the stated goals of both the Governor and the Commissioner: providing the companies with the necessary tools for their operations and striving for rate adequacy, yet providing ample protection to consumers against excessive rates.

Under the Clifford formula methodology, the maximum profit on the surplus supporting the insurer's entire P&C book of business was attainable, and no significant transfer of capital from New Jersey subsidiaries occurred. Consequently, the Department does not anticipate that such a transfer will occur after the new cap established by the ROE-based standard ratemaking methodology goes into effect. If the Department receives indications that transfers of capital may be contemplated, it can address such situations on a company-by-company basis. The option afforded to insurers to use an alternate ratemaking methodology provides an avenue by which companies can apply based upon their unique circumstances, which would include the relationship between the amount of their total surplus and the amount of the surplus supporting their private passenger auto insurance business in New Jersey.

Federal Standards Statement

A federal standards analysis is not required because the adopted amendments are not subject to any federal requirements or standards.

Full text of the adoption follows (additions to proposal indicated in boldface with asterisks ***thus*;** deletions from proposal indicated in brackets with asterisks *[thus]*):

11:3-16.2 Definitions

The following words and terms, when used in this subchapter, shall have the following meanings, unless the context clearly indicates otherwise:

. . .

"Expenses" means that portion of a rate that is attributable to commissions and brokerage, other acquisition expenses, general expenses, and taxes, licenses and fees ***in addition to assessments for losses and costs relating to uninsured motorist coverage**

<u>and pedestrian personal injury protection</u>*. Expenses do not include Automobile Insurance Risk Exchange ("AIRE").

. . .

11:3-16.10 Rate calculation using standard ratemaking methodology

(a) Investment income shall be treated by group of coverage as follows:

1. The calculation of the underwriting profit and contingency provision, taking into account investment income on loss reserves, loss adjustment expense reserves, unearned premium reserves and policyholder surplus shall be calculated in accordance with the Return-On-Equity (ROE) methodology, wherein, until revised pursuant to the procedure set forth in (a)10 below, the target after-tax ROE shall be limited to a maximum of 12.0 percent as a ratio to surplus or the company's target ROE, whichever is lower, inclusive of projected investment income on loss reserves, loss adjustment expense reserves, unearned premium reserves and policyholder surplus. The premium-to-surplus ratio (P/S) used for this calculation shall be limited to a minimum of 2/1, or the company's actual P/S as of the end of the latest calendar year, whichever is greater. The ROE calculation shall reflect investment income earned on surplus, based on past rates of return calculated in (a)8 below, to derive a net return on policyholder funds. The target return on policyholder funds shall be converted to a percentage of earned premium. Investment. income earned on policyholder funds shall be calculated using a discounted cash-flow method with the cash-flow patterns provided in N.J.A.C. 11:3-16.9(c); otherwise the company shall provide the information contained in (a)2 through 6 below. The allowance for profit and contingencies used in deriving the

expected loss and loss adjustment expense ratio shall be net of all investment income in policyholder funds and surplus, stated as a percent of earned premium and converted to a pre-tax basis.

i. Factors the Department will consider in *__approving an insurer’s target ROE or in__* determining future adjustments to the maximum ROE permitted __shall include *the insurer’s method of doing business, the cost of capital and other relevant economic considerations of the insurer, as well as__ interest rate levels, nationwide insurer return on equity levels, the level of competition in the New Jersey Auto insurance market, ROE levels in other industries, and such other occurrences or conditions that may impact upon the adequacy of ROE, as reflected in AM Best Reports, NAIC profitability reports, return on surplus, the Federal prime interest rate, and other *__publicly available independent__* indices of similar reliability.

2. – 8. (No change from proposal.)

(b) Underwriting expenses provision shall be determined as follows:

1. – 9. (No change from proposal)

10. In accordance with (a)1 above, the Commissioner may issue an Order, no less frequently than once every two years, to adjust the maximum allowable ROE. Before issuing such an Order, the Commissioner shall publish a notice in the New Jersey Register, and provide secondary notice in the manner prescribed in N.J.S.A. 52:14B-4(e) regarding notices of intent with respect to a proposed rulemaking proceeding. The notice shall indicate that the Commissioner has determined that a reevaluation of the current maximum ROE specified in this rule is necessary. The notice shall identify those factors,

as set forth in (a) above, which the Commissioner intends to consider when conducting his or her analysis ***, a preliminary range for the change in the ROE, and the factors considered to determine that range*.** The notice shall further indicate that interested parties may submit comments upon the notice, including comments upon other factors which might be considered in addition to those mentioned in the notice. The comment period provided by the notice shall be not less than 30 days.

i. and ii. (No change from proposal.)

(c) –(i) (No change from proposal.)

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