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, 16.6, 16.8, 16.10, 16.11 and Appendix Exhibits C, E and H

Adopted Repeals: N.J.A.C. 11:3-16 Appendix Exhibits AI, AII and K

Adopted New Rules: N.J.A.C. 11:3-16 Appendix Exhibit A

Proposed: October 7, 2002 at 34 N.J.R. 3475(a)

Adopted: April 3, 2003 by Holly C. Bakke, Commissioner, Department of Banking and Insurance

Filed: April 3, 2003, as R. 2003 d.173, **with a technical change** 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; 17:1-15(e) and 17:29A-1 et seq.

Effective Date: May 5, 2003

Expiration Date: January 4, 2006

Summary of Public Comments and Agency Responses:

The Department received four written comments on the proposal: three from insurers (Allstate New Jersey Insurance Company, New Jersey Manufacturers Insurance Group, State Farm Indemnity Company), and one from a trade association, the Alliance of American Insurers.

COMMENT: One commenter expressed concern with N.J.A.C. 11:3-16.3(a) which permits a filer to submit any other data it believes to be relevant in justifying proposed rate changes. The commenter stated that this provision permits automobile insurers to file an alternative methodology that it uses in other states in addition to the standard ratemaking methodology. The commenter stated that the Department has historically only accepted the standard methodology. The commenter contends that one way to attract new auto insurers to New Jersey is to permit carriers to use the same ratemaking methodologies that they use in other states. The commenter believes that the requiring of a different ratemaking methodology is a barrier to new carriers entering New Jersey. The commenter suggested that the Department consider alternative ratemaking methodologies that the carriers use.

The commenter suggested amending N.J.A.C. 11:3-16.3(a) to read (additions in boldface):

"The data requirements set forth in this subchapter are minimum requirements. The filer may submit any other data it believes to be relevant in justifying proposed rate changes. <u>The Department shall consider an alternative ratemaking methodology that is proposed by the filer that the filer uses in other states. The filer shall list the other states in which the methodology is used."</u>

RESPONSE: While the Department appreciates the commenter's suggested amendment to N.J.A.C. 11:3-16.3(a), because no amendments were proposed to this subsection, the commenter's comments are beyond the scope of this proposal. The Department, however, will consider implementing the commenter's suggestion in a future rule proposal.

COMMENT: One commenter contends that proposed N.J.A.C. 11:3-16.6(a)8 states: "data described in N.J.A.C. 11:3-16.8(c) (loss development) and … ." The commenter stated that there is a typo in the cross-reference. Loss development is described in subsection e of N.J.A.C. 11:3-16.8, not subsection (c). Subsection (c) deals with the accuracy of rate classifications.

Proposed N.J.A.C. 11:3-16.6(a)8 should be amended to read as follows: "Data described in N.J.A.C. 11:3-16.8(e ~~c~~) (loss development) and …".

RESPONSE: The Department agrees with the commenter and has amended these rules accordingly.

COMMENT: One commenter objected to N.J.A.C. 11:3-16.9(a)4, which states that all data shall be on a direct basis excluding AIRE assessments or reimbursements. The commenter stated that it prohibits automobile insurers from including catastrophe reinsurance and AIRE assessments in its expense load. The commenter stated that the effect of this is to block required and prudent expenses from the rate base in order to artificially lower indicated rate needs.

The commenter noted that it is prudent for insurers to purchase catastrophe reinsurance to cover comprehensive losses resulting from a hurricane or other catastrophe. The commenter stated that it is prudent for automobile insurers with limited surplus to reinsure against such a catastrophe. For many insurers, the cost of this reinsurance can even be specifically identified for New Jersey automobile comprehensive coverages. The commenter believes all prudent expenses should be included in the rate base.

The commenter stated that net AIRE assessments (net of AIRE reimbursements) are expenses that an automobile insurer is required to pay in New Jersey. An insurer pays net AIRE expenses if its proportion of zero threshold choosers is greater than the average for the industry as a whole. The net AIRE expense offsets the above average extra premium that the insurer collects from its zero threshold choosers. The commenter contends that if net AIRE expenses are not included in their rate base, those insurers will have their rates reduced without their expenses being reduced.

The commenter believes that by allowing insurers to put prudent and required expenses into their rate base it will help attract new automobile insurers to enter the New Jersey automobile market. The commenter contends that the prohibition upon including prudent or required expenses in their rate base is a barrier to insurers entering New Jersey.

The commenter suggested that the Department amend N.J.A.C. 11:3-16.9(a)4 to read (additions in boldface; deletions in brackets):

> "4. All data shall be on a direct basis except that catastrophe reinsurance may be included as an expense. Expenses shall exclude [excluding] LAD fees [and AIRE assessments, AIRE, allocative and AIRE investment income]."

RESPONSE: The Department disagrees with the commenter. In N.J.S.A. 17:29A-5.6k the definition of "private passenger automobile insurance business" states that it means direct insurance on private passenger automobiles excluding personal excess liability insurance and insurance on commercial vehicles. Therefore, the inclusion of the re-insurance expense in the rate base is statutorily proscribed. Accordingly, the Department has not permitted AIRE to be reflected as an expense in the past.

COMMENT: Three commenters expressed concern with proposed N.J.A.C. 11:3-16.10(a)8 which provides that the interest rate used in the rate calculation shall be a simple average of the calculated investment income yield for each of the latest two years, or the estimated investment income yield for the current year, whichever is higher.

One commenter noted that the Department's amendment is an improvement, but that it does not go far enough. The commenter suggested that the Department use a shorter time period, such as six-months, as a basis for projecting investment income yield. The commenter contends that the six-month period would permit a more accurate prediction of the interest the carrier actually will be able to earn.

The commenter also expressed concern with the “whichever is higher” requirement, which mandates that the “higher” of the yield of the latest two years and the estimated yield for current year must be used regardless of which is likely to be a more accurate predictor of investment return. The commenter stated that if the objective is accuracy, the formula more likely to predict the interest the carrier will earn should be used.

A second commenter stated that although the Department’s amendments can be expected to produce a more realistic prediction of the yield, the proposed amendments will still overstate prospective yields in a time of declining interest rates like the present. The second commenter offered two alternatives that they believe will more accurately reflect current market conditions.

The second commenter also suggested shortening the period of time to six months of actual yield (as stated above by the previous commenter), rather than one or two years, in order to provide a more accurate picture of what insurers can expect to generate in investment income based on the premium funds they are currently receiving. The commenter stated that an amendment allowing the use of a six-month average yield for two-year treasury bonds would be appropriate. The commenter stated that this method is preferable to the one proposed by the Department because Treasury bonds have minimum or no risk and would therefore eliminate the possibility of policyholders having to share in the investment risk of the company. In addition, the two-year time period of Treasury bonds approximately matches the duration of automobile reserves and payouts.

A third commenter stated that requiring the use of the "higher" of two measures will just artificially inflate investment income yields because the lower measure will be correct some of the time. The commenter stated that a more accurate and consistent means of selecting investment income yields would be to simply choose one of the methods as the standard method. The average investment yield for the latest two years available would probably fit best with the standard methodology that the Department is requiring. The third commenter also suggested deleting the last line which states: "or the estimated investment income for the current year, whichever is higher."

RESPONSE: The Department disagrees with the commenters. The Department's calculation is based on what the filer actually earned over the past two years. The Department does not believe that it is appropriate to change this to a shorter time frame because rates are assumed to be in effect for a minimum of one year and reserves are invested on a longer term basis, so as to match cash flow requirements. A one-to-two year rate is more stable than a shorter period like six months. The Department's rules are designed to be in effect for the long-term and take into account all economic climates. Consequently, crafting the calculation to account for present market conditions that may not persist in the future would not be appropriate. Thus, the Department has concluded that the calculation as proposed best reflects its determination that if rates are increasing it is appropriate to use a higher projection and if rates are stable the two-year average is appropriate.

COMMENT: One commenter expressed concern with N.J.A.C. 11:3-16.10(a), the rate calculation using standard ratemaking methodology. The commenter suggested that investment income should be treated by group of coverages as follows:

"1. The calculation of the underwriting profit and contingency [loading] provision taking into account investment income on loss, loss adjustment expense, and unearned premium reserves shall be calculated in accordance with the Clifford Formula methodology, wherein the combined after-tax profit from underwriting and investment income on loss, loss adjustment expense, and unearned premium reserves is 3.5 percent of premium. The profit and contingency provision may 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. Alternatively, an insurer may use targeted returns on equity (ROE) commensurate with individual company risk, the cost of capital and other considerations deemed relevant by the filer. An insurer that uses targeted ROE must provide actuarial and investment return support in its voluntary private passenger automobile insurance filing. Targeted underwriting profits shall be developed using insurer's actual investment return and leverage ratio (premium to surplus)."

RESPONSE: The proposed amendment to N.J.A.C. 11:3-16.10(a) was intended solely to clarify the wording of this provision. The inclusion of an alternative to the Clifford Formula in the rule as suggested in this comment would be a substantive change that would require this provision to be reproposed (see N.J.A.C. 1:30-6.3). The Department is reviewing the Clifford Formula methodology and may, in the near future, propose modifications that will be subject to public comment.

COMMENT: One commenter suggested that in Exhibit A, "Prior Approval Filings," changes to the exhibits in the rate filing regulation and related regulations, such as the excess profits regulation, should be made to be consistent with the Departments' proposed amendments.

1) The commenter suggested amending N.J.A.C. 11:3-16.10(a)1 pertaining to investment income as follows (additions in boldface):

> 1. **All filers must include in their filings an explanation and documentation to support the filer's targeted rate of return taking into consideration the manner in which the company does business, the cost of capital and other considerations deemed relevant by the filer**. The calculation of the underwriting profit and contingency loading taking into account investment income on loss, loss adjustment expense, and unearned premium reserves shall be calculated in accordance with **generally accepted actuarial principles and standards of practice.**

The commenter contends that, in this way, the Department would still be able to review and approve the targeted rate of return selected as part of the prior approval process. The commenter believes that filers should have the option to continue to use the Clifford Formula, however its use should not be mandated.

RESPONSE: The proposed amendments to N.J.A.C. 11:3-16.10(a) were intended solely to clarify the wording of this provision. The inclusion of an alternative to the Clifford Formula in the rule as suggested in this comment would be a substantive change that would require this provision to be reproposed (see N.J.A.C. 1:30-6.3). The Department is reviewing the Clifford Formula methodology and may, in the near future, propose modifications that will be subject to public comment

COMMENT: One commenter stated that N.J.A.C. 11:3-16.10(b)6 and Appendix Exhibit H place maximum limits on Expense Factors, which limit the expense provision of the filer to no more than the weighted average expense provision for the 20 largest New Jersey automobile insurers that use the same general marketing method as the filer. The commenter contends that this provision penalizes insurers that wish to provide extra policyholder service or extra underwriting reviews to properly price policies. The commenter stated that whether such extra expenses are prudent is a matter for the automobile insurance consumer to decide (he or she is the one receiving the extra service), not the Department. The commenter asserts that this limitation may be a barrier to insurers entering the New Jersey automobile insurance market.

The commenter suggested that N.J.A.C. 11:3-16.10(b).6, and Appendix Exhibit H should be deleted.

RESPONSE: As no amendments were proposed to N.J.A.C. 11:3-16.10(b)6, the commenter's comment is beyond the scope of this proposal.

COMMENT: One commenter urged the Department to cease requiring the "Clifford Formula" in the rate filing process. The commenter contends that the continued application of the "Clifford Formula" discourages automobile insurance competition and serves as a deterrent to attracting additional capital to the New Jersey automobile insurance market.

The commenter stated that both existing insurers and potential new insurers view the Clifford Formula as an impediment to committing additional capital and increasing competition. The commenter believes that the Clifford Formula does not provide flexibility and will not attract additional capital to the market because it prevents insurers from earning return on equity which is sufficient to attract and retain capital from investors. The net effect of the continued use of the Clifford Formula is that it discourages additional capital investment and reduces competition, which ultimately leads to fewer options for policyholders.

The commenter contends that it is time to adopt a more realistic approach which reflects current economic realities. The commenter stated that the Department's rate filing rules should eliminate this arbitrary, capricious and unreasonable approach that has no basis in statutory law. The commenter suggested that the Department use a company-specific standard where insurers have the ability and obligation to use individual targeted returns, which are more in line with current economic theory and reality. The commenter believes that the latter approach simply means that insurers will be permitted to target returns expected by their investors and would be a significant step in the right direction to attract additional capital and competition to the New Jersey automobile insurance marketplace. The commenter contends that the expected return on equity is the measure evaluated by investors when determining where to invest money.

The commenter believes that a more realistic approach and one which reflects current economic realities is to change the Department's rate filing rules to replace this "one size fits all approach" with an approach that provides for individual targeted operating returns in rate making.

RESPONSE: As was discussed in the responses to two prior comments, a substantive revision to the rate filing formula is beyond the scope of this proposal and would require publication of a revised proposal. The Department is reviewing the Clifford Formula methodology and may, in the near future, propose modifications that will be subject to public comment.

Federal Standards Statement

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

<u>Full text</u> of the adoption follows (addition to proposal indicated in boldface with asterisks ***<u>thus</u>***; deletion from proposal indicated in brackets with asterisks ***[**thus**]***):

11:3-16.6 Insurer filings for rates requiring prior approval

(a) Any insurer that desires to modify its rates or rating systems in a manner other than that provided by N.J.S.A. 17:29A-46.6 shall provide the following information in support of its application:

1. - 7. (No change from proposal.)

8. Data described in N.J.A.C. 11:3-16.8 ***[**(c)**]*** ***(<u>e</u>)*** (loss development) and 16.9(c)2, 3 and 4 (cash-flow patterns) shall be submitted in written copy and, except for purely textual information, on an MS-DOS formatted 3.5 inch 1.44 MB disk or a CD-ROM. Filers with fewer than 20,000 exposures in the prior year are exempt from submitting the formatted disk.. The information shall be provided in a Microsoft Excel 97 or compatible spreadsheet. The left and top margins of each page shall indicate the row and column respectively of all data on the page. Each page of written copy shall also display in the bottom right corner the name of the computer file and disk on which it is contained. All calculated values shall be given as a formula in the spreadsheet.

(b) - (c) (No change from proposal.)

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