EXCERPTS FROM
PROPOSITION 103 TESTIMONY
(Declaration)

J. Robert Hunter
III. The Commissioner's Protocol

A. **Purpose of Protocol Forms**

6. Attached to this Declaration is a set of eight forms, including instructions, that I suggest the Commissioner adopt as her protocol to determine if an exemption from the Rollback requirements should be granted. The forms are:

   Form 1 - Determination of Allowable Costs (Excluding Variable Expenses)
Form 2 - Determination of Constitutionally Required Revenue from Premiums for the Company/Line
Form 3 - Determination of Constitutionally Required Revenue from Premiums for the Group
Form 4 - Determination of Percent Increase Needed from Rollback Level of Proposition 103
Form 5 - Determination of Required Surplus
Form 6 - Determination of Premiums at Proposition 103 Rollback Level
Form 7 - Determination of Expense Disallowances and Capping to Efficient Level of Cost
Form 8 - Recapitulation of Key Findings

7. I will discuss the Forms at length below, covering the departures I see as required from "business-as-usual" ratemaking used in other jurisdictions (particularly vital during the Rollback period).¹

¹In my review of 25 applications for exemptions, I found that, with only 2 or 3 exceptions, insurer ratemaking was carried out in the business-as-usual fashion, although the Department of Insurance forms did supply more information than is typical in other states. There was no consideration given to any disallowances for expenses that should not be borne by ratepayers. Filers used reserves (including IBNR in some cases) without any test of potential reserve strengthening or redundancy. Rarely did I find a statement as to what rate of return was required, trend and loss development was applied as usual, and so on.

There is utmost need for consistency in applications for exemptions. Some companies vary the database, suggesting an effort to get the answer they want. Most insurers use one year of data, some use two or three. But, for example, Reliance, for commercial auto, uses four years, 1985-1988, each later year better than the earliest (for liability 1985's projected loss ratio was 111.4%
8. A general issue arises in relation to whether the Rollback test should be applied line-by-line, company-by-company, or on a group-wide, all lines combined basis. The forms assume that the essential calculations will be made line-by-line, company-by-company but the final Rollback test will be group-wide, all lines combined. The forms could easily accommodate a wholly company-by-company, line-by-line approach, however.

9. Actuarially, there is little difference between the line-by-line, company-by-company approach as compared to the company-wide, all lines combined approach. The Rollback is a one-time event. In the later phase -- the prior approval phase -- line-by-line, company-by-company is necessary because of problems with continuing cross subsidies. In the Rollback phase, it is the constitutional test of minimum required prices that argues for use of total group, all line information.

B. Form 1 - Determination of Allowable Costs (Excluding Variable Expenses)

10. I have determined to minimize argument about reserves by adopting an accepted actuarial approach of calculating reserves versus 69.2% in 1988; for physical damage the respective figures are 98.4% and 47.9%). The Rollback, at least part of it, might be indicated if the latest year or two were used rather than a four-year base.

Some filings contain no data, relying on “judgment.” Progressive filed Private Passenger Excess Liability using a sample of 55 policies premiums before 1987 and compared these with current rates which led them to say their prices comply, but filed no experience nor did it lower prices. Reliance, in its commercial auto filing, uses undisclosed data and methods to produce loss development.
through the use of paid losses only. Paid losses are known and absolute; reserves are estimates. Particularly since some reserves which would be used in seeking exemptions were reserves established after Proposition 103 passed, use of reserves will leave major doubts in the public's mind. Reserves are subject to manipulation and remarkable changes over time. For example, reserves are strengthened at times of high profits (as in recent years), and weakened when profits are low. Incurred-but-not-reported (IBNR) reserves are the most subject to manipulation. These are the insurer's estimates of ultimate payouts that they will make on claims that they don't even know about yet. As a percentage of losses paid, national IBNR jumped from 55% in 1985 to 146% in 1988 for Farmers; from 20% in 1985 to 59% in 1988 for the California Auto Club. The most startling evidence of the poor prediction that reserves make is the well-known "cycle," during which profits range from somewhat inadequate to grossly excessive, albeit rates are consistently based on reserve estimates. The proposed method

---

Nationally, losses paid fell from 24.7% of incurred losses in 1984 to 14.2% in 1988 for American International Group's first reporting of accident year claims for all lines, 40.6% to 24.5% for CIGNA, 51.4% to 44.8% for State Farm, 32.1% to 25.8% for Aetna, 41.2% to 33.9% for Farmers Insurance Group. In California, reserves jump around even more widely. For example, Travelers had other liability incurred losses of $145 million in 1987, of which $47 million was paid, in 1988, the figures were $49 million paid, but incurred was negative $46 million. CIGNA had $61 million of other liability payments in 1987 when incurred losses were $42 million; but in 1988, the respective figures were $68 million paid and $100 million incurred; America International had $22 million paid, $25 million incurred for private passenger auto liability in 1987, but $25 million paid, $36 million incurred in 1988.
should eliminate the public's doubts about reserves, a very important goal given the public's abysmal image of insurer pricing.

11. The method I propose is to use accident year paid claims and allocated loss adjustment expenses coupled with paid loss development to generate an estimate of ultimate losses that will be paid. This produces an estimate of incurred losses using only actual payouts, thus eliminating doubt about the accuracy of reserves. The process of loss development is well established in actuarial literature. Loss development looks back over recent years to see how initial payments (and reserves if incurred losses are the starting point) "develop" (i.e., ultimately payout). While incurred losses coupled with incurred loss development is more usually used, paid losses with paid loss development is also used. Often, if reserves are suspected to be changing -- either by being strengthened (the instant concern) or weakened -- paid losses and paid loss development is used to test the incurred losses and incurred loss development results.

12. Since Form 1 calculates only costs and not revenues, I suggest that only accident loss year information be used (not policy year or calendar year, which would include very old information). To keep a balance of stability and responsiveness, I have adopted use of the mean of the three most recently available accident years (with the latest year being no older than the accident year ended June 30, 1988).

13. If an insurer believes its experience is not credible, an affidavit by a qualified expert should so attest. Assuming
that a group-wide, all lines test is adopted, credibility should be viewed on that overall basis. In no event, however, should applicants for exemptions be allowed to submit data other than their own data. To the extent data are not fully credible, the Department of Insurance should apply the appropriate credibility to the insurer's indicated Rollback level with the complement of the credibility to be applied to the Proposition 103 Rollback level.

14. The trend factor will be line-by-line. I strongly suggest that the annual trend factors be promulgated by the Department of Insurance following a generic hearing on the matter of trends. The hearing should cover fixed expense trends and premium trends as well. Since trend measures such factors as changes in repair costs, medical costs, impact on frequency of gas price changes, house values, new car purchases, etc., the generic nature of trend is obvious. Indeed, generic sources of data -- such as the average weekly wages of fire and casualty insurance employees, fast-track claims and frequency data, gas price information from the U.S. Department of Transportation, etc., are routinely used in pricing. To review these facts in every case -- over and over -- would be inappropriate.

15. The number of months of trend to use to project the developed losses to the midpoint of the Rollback period (May 8, 1989) will depend upon the experience data available. If, for example, the latest year was year ended December 31, 1988, the average date of accident would be June 30, 1988, so 10 months, 8
days of trend would be required. The next earlier year would require 12 more months of trend, and so on.

16. Part B of Form 1 displays the allowable fixed expenses for unallocated loss adjustment expense (ULAE), other acquisition, and general expenses. The derivation of these amounts is discussed below, in my discussion of Form 7.

17. The annual trend for fixed expenses should be determined as part of the generic hearing on trend.

18. The total allowable costs (excluding variable expenses) is the sum of the mean total trended and developed losses and ALAE and the Fixed Expenses.

C. Form 2 - Determination of Constitutionally Required Revenue from Premiums

19. A generic hearing should be held to determine the required rate of return on surplus (pre-tax) for each line of insurance. Based on current indications I have seen in other states, I anticipate that the current constitutional need is about 11% to 15% post-tax, about 14% to 19% pre-tax. For the current Rollback test, the bottom of the range should be adopted as the standard.

By contrast, in its application for exemption, Farmers Insurance Exchange asks to maintain the current rate level for

---

³The effective federal tax rate for property/casualty insurers is lower than for most other industries. For example, the U.S. General Accounting Office found that the property/casualty insurance industry paid no federal taxes for the decade ended 1986, although $85 billion of profits were realized.
homeowners even though it produces, according to Farmers, a 21.32% return on policyholder surplus (even on the basis of its own methodology and assumptions for calculating return). Others make similar claims: Allstate homeowners current level requested produces a 16.2% return on equity, Progressive Casualty’s Travel Trailer filing shows a 15.5% return at Proposition 103’s Rollback level, 35.9% at current rates, yet asks for current. Other Progressive filings show similar high returns. Twentieth Century claims to have earned 35.3% on homeowners and 23.5% on private passenger auto in 1988, yet ask for an exemption.

Calculation of the appropriate rate of return lends itself to an overall generic hearing. The testimony of economists, venture capitalists, stock market experts, etc., is required. The determination of required returns is complex. To hear this over and over would be time consuming and unnecessarily expensive.

20. The determination of required (or target) returns is documented in the NAIC Study on Investment Income (See NAIC Study of Investment Income, Supplement to the Proceedings, 1984, Vol. II). The complexity of the issues involved is clear from the huge amount of material contained in the NAIC report. This generic hearing would determine the constitutionally required minimum rate of return on surplus needed to produce a fair rate of return for each line to which Proposition 103’s Rollback requirements apply. What is crystal clear is that use of a 5% of
premium underwriting profit margin in setting rates is not justifiable.\textsuperscript{4}

21. The selected minimum target (pre-tax) return ratio will be applied to the surplus required for the line under review. The calculation of such surplus is done on Form 5, as discussed below.

22. The sum of return on surplus required plus total allowable costs is the revenue requirement for this line for this insurer, excluding variable costs.

23. Prior to loading for variable costs, the income from investments (net of investment expenses) is to be deducted from the revenue requirements. As the NAIC recommends,\textsuperscript{5} I also suggest a total return approach for rate regulation which includes investment income from all sources including reserves and surplus. To smooth variations in capital gains, I suggest a three-year mean

\begin{quote}
\textsuperscript{4}For example, in the NAIC Study of Investment Income, Supplement to the Proceedings, 1984, Vol. II, the NAIC concluded:

"If the industry were to currently earn 5\% of premiums in addition to investment income (which historically it has not), its total rate of return on net worth after tax would be approximately 25\%. The 5\% of premiums used to establish indicated rates bears no demonstrable relationship to underwriting profit margins actually targeted or achieved.

"The Task Force has not been able to find any economic justification for the traditional 5\% profit allowance. Without being related in some way to an investment base (either assets or net worth), a return on sales or premiums has very limited value as a measure of profitability; for purposes of comparing profits with those of other industries, the measure is meaningless. The Task Force finds that the use of 5\% or any other arbitrary and unsupported percentage of premiums is no longer appropriate in the regulation of property/casualty rates."
\end{quote}

\textsuperscript{5}\textit{Ibid.}
for realized capital gains. Unrealized capital gains are not included since some double counting with realized gains might occur.

24. To the extent that the surplus allowed (as determined on Form 5, discussed below) is less than that the insurer group actually holds, the investment income and capital gains are to be lowered by a percentage determined by a ratio of the required surplus to the actual surplus.

25. Investment income and capital gains are to be allocated to California and the line based on the ratio of California line reserves to national reserves.

26. Miscellaneous income, such as premium financing income, membership fees, etc., related to the line are to be included in revenue. If such income is collected by a non-insurer affiliate, it is still to be reflected.

27. The constitutionally required revenue from premium is the revenue requirement (excluding variable expenses) less the total income other than premiums, grossed up to include the California premium taxes and allowable commission and brokerage expenses. Allowable commission and brokerage expense is determined on Form 7. Actual California premium tax is to be used.
D. **Form 3 - Determination of Constitutionally Required Revenue from Premiums for the Group**

28. This Form sums the constitutionally required revenue from premiums for each company for each line to obtain the total group constitutionally required revenue from premiums.

E. **Form 4 - Determination of Percent Increase Needed from Rollback Level of Proposition 103**

29. Form 4 compares the constitutionally required revenue for premiums for the group with the premiums at 103 Rollback level (which is determined on Form 6, discussed below). This gives both a dollar and percent exemption increase indicated. This is to be capped at no more than current rates, also shown on Form 6, discussed below.

30. Form 4 can be used on a line-by-line, company-by-company basis if it is determined to test the Rollback in that way.

F. **Form 5 - Determination of Required Surplus**

31. This Form deals with a very important concept, the surplus required to back up the enterprise (this is the equivalent of a "used and useful" analysis in public utility ratemaking).

32. "Surplus" is the difference between assets and liabilities. Put another way, surplus is the amount of money insurers hold in addition to the funds they have set aside as reserves to pay projected claims and to cover unearned premium. Claims are paid out of reserves, not surplus; but surplus
represents an extra cushion of safety out of which claims could be paid if actual payouts exceeded predicted payouts.

33. Both the traditional rule of thumb in the insurance industry and the Insurance Regulatory Information System ("IRIS") guideline hold that insurers should write no more than $3 of premium for each dollar of surplus; writing more premium to each dollar of surplus would leave an inadequate safety margin, regulators believe. Typically, the industry's actual premium to surplus ratio has been much more conservative than 3:1, i.e., insurers have held sufficient surplus to provide a very safe cushion. For example, over the last 20 years, the industry's premium to surplus ratio has approximated 2:1, ranging from a low of 1.5 to 1 in 1967 to a high of 2.8 to 1 in 1975. (See Exh. A.) A 2:1 ratio is considered a very safe ratio; a well-known insurance brokerage characterizes it as "correct, conservative and comfortable." Report by Alex. Brown & Sons, Best's Management Reports, June 27, 1988. In 1988 the premium to surplus ratio was 1.8:1; insurers wrote $199 billion in premium and had $110 billion in mean surplus (year end 1987 surplus was $104 billion, year end 1988 surplus was $116 billion -- See Exh. B).

34. Premium to surplus ratios of less than 2:1 are conservative and may contain what is known as "surplus-surplus." As the New Jersey Insurance Department and Supreme Court have recognized in an automobile liability insurance case, all surplus in excess of that amount of surplus that would produce a premium to surplus ratio of 2:1 is surplus surplus. In Re Insurance
Ratina Board (1973) 63 N.J. 413, 307 A.2d 604. Surplus-surplus is not necessary to support an insurer's insurance business, and thus not subject to any real risk. The New Jersey Department of Insurance has therefore held that insurers are entitled to no more than a 1% return on their surplus-surplus. It relied on a special report to New York's Superintendent of Insurance, entitled "The Concept of Surplus Surplus," which contrasted surplus-surplus with required surplus as follows:

"The 'required surplus' is one that will be adequate to cover for a reasonable period of time any losses and expenses larger than those predicted and any variations in the crucial factors of the operation. Any surplus beyond this cover is surplus surplus which, by definition, is unneeded; it may be treated quite differently in the process of regulation."

35. In 1989, some insurers, including many of the largest in California, may have very substantial surplus-surplus. For example, State Farm Mutual Auto Insurance Company, the largest auto insurer in both California and the nation, was writing at a 1.3:1 ratio (Total year end 1987 surplus of $14.0 billion, premium written of $18.6 billion.) Other major California insurers may have large surplus-surplus, as the following table demonstrates:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Hartford Fire</td>
<td>.92 to 1.00</td>
</tr>
<tr>
<td>Lumbermans Mutual Casualty</td>
<td>1.29 to 1.00</td>
</tr>
<tr>
<td>United Services Automobile Assoc.</td>
<td>1.00 to 1.00</td>
</tr>
</tbody>
</table>
36. Form 5 adjusts to eliminate overcapitalization, or surplus-surplus, by limiting the amount of surplus allowed in the revenue requirements. Part A of the Form compares the actual national reserve to surplus ratio for the group with the floor ratio established by the Commissioner following a generic hearing on the subject. The Commissioner must determine when surplus no longer reasonably serves to back up the reserve liabilities and therefore should not be rewarded by extra policyholder/generated revenue.

37. If an insurer has surplus-surplus, I propose that no reward for such excess be required of policyholders and, likewise, that the investment income and capital gains attributable to such excess be fully excluded from policyholders and allowed to flow completely to the owners of the company (see discussion above at paragraph 24).

38. Part B of Form 5 calculates the surplus required for the company and line.

39. Regardless of the decision on group or company as the basis of the Rollback test, I recommend that the consolidated group Annual Statement be used as the determination of the reserve/surplus ratios because of inter-company arrangements pertaining to accounting and reinsurance which makes company specific surplus tests difficult.
G. Form 6 - Determination of Premiums as Proposition 103 Rollback Level

40. This Form shows the latest three-year rate level history (that is, the date of each rate change and the percentage change) and the latest year total limits premium. Calculations using these data are undertaken to show premiums at current level, premiums at projected level for the Rollback year and premiums at Proposition 103's Rollback level (i.e., the level in effect as of November 8, 1987, less 20%).

41. These are routine actuarial calculations using what is identified in the literature as "on level" factors calculated using "parts of the year" parallelograms. Stated simply, the most recent year's premium will not necessarily be current level if a rate change has occurred at any time since the start of the experience. If such a change has occurred, adjustments will be needed to obtain the current level premium. Similarly, if rates changed at any time between November 7, 1987, and the end of the experience period, adjustments will have to be made to the premiums to get to the Rollback level (following which a 20% reduction must be applied).

42. For some lines of insurance, such as homeowners, premium trends are needed to project premiums to the Rollback period. This is because the exposure base for determining premium automatically changes with, for example, inflation. As an example, again using homeowners insurance, the so-called "inflation-guard" endorsements automatically suggest more coverage to consumers.
This pushes premiums upward. Premium trend should be part of the generic hearing on trend and the annual trend factor for the lines to which these trends apply determined at that hearing.

H. Form 7 - Determination of Expense Disallowances and Capping to Efficient Level of Cost

43. Form 7 is intended to adjust reported insurer expenses to a reasonable level. Property/casualty insurance companies are unusually inefficient. Whereas approximately 85 cents of the group health insurance premium dollar is returned to the policyholder, and 95 cents of the utility dollar is returned to the ratepayer, only 65 cents of the auto liability insurance premium dollar is returned to the policyholder -- the rest goes to pay executive salaries, agents' commissions, defense lawyer fees, and other expenses. To be sure, some insurers are both efficient and effective in providing service.

44. In the automobile and homeowners insurance area, such insurers as USAA and Amica Mutual are always "winners" in service rankings (see, for example, Consumer Reports, October, 1988, p. 628) while offering low front-end prices and/or large dividends.

45. I have reviewed several major lines of insurance in the attached chart (see Exh. C). In Private Passenger Automobile Liability Insurance the industry average total expense level is 35.3%, but USAA, California's eighth largest auto insurer, provides its well-known superior service at a 20.0% expense level. If nothing else changed, but the average insurer became as efficient as USAA, the industry as a whole could reduce its prices by 19.1%.
Companies that are less efficient than average could cut prices even more. For example, Continental Insurance Company has an expense level of 45.0%. It could cut its rates by 31.3% if it became as efficient as USAA.

46. Similar analysis shows that individual lines average prices could drop, based solely on improved efficiency, by the amount shown in the final two columns of the exhibit. Note that the higher cost insurers could reduce their costs by more than the reduction in rates required under Proposition 103 if they became as efficient as the efficient writers in the market.

47. In fact, insurers have already begun to reduce costs in response to Proposition 103. For instance, Progressive Insurance Company has lowered commissions by 10 points, a move that alone will allow it to freeze its rates at the rolled back level for a year (assuming annual policies) while earning its current profit. (See "Calif. Insurer Slashes Agents' Commission to Ease Sting of 103," Journal of Commerce, December 15, 1988.) In addition, the December 9, 1988, Best's Rating Monitor notes that "companies have already started laying off staff and cutting commissions to control expenses" as a result of Proposition 103.

48. Form 7 first lists specifically disallowed expense items which are deducted from the national experience (since the Insurance Expense Exhibit is a national document and easily verified for total costs). Certain items should be borne below the line (by stockholders) rather than above the line (by ratepayers). Those expense items not demonstrated by the insurer...
as giving a direct and identifiable benefit to ratepayers should be borne out of profits. I have listed some obvious candidates; political and charitable contributions are fine, but not for ratepayers, who have no say in the selection of candidate or charity -- both of which may indeed be opposed by the ratepayer's interest. For example, in their applications for exemptions, State Farm showed $7.5 million and Farmers $2.7 million spent on initiatives during 1988; 20th Century spent $1.4 million on political contributions made to 61 candidates and groups during 1988. Penalties and fines for the insurer's misbehavior should not be borne by the ratepayers. If the insurer loses an employee's discrimination claim, the policyholders should not pay for that. Likewise, bad faith costs are intended to be borne by the stockholders. Lobbying serves no purpose for ratepayers, nor does entertainment. Costs for institutional advertising which puffs up an insurer but gives no useful information to the ratepayer should be disallowed. Transactions with affiliates should be disallowed unless the company can demonstrate that an arms-length negotiation produced a competitive price.

49. Following the disallowance procedure, a cap on costs is imposed. I suggest that this cap be set by the Department of Insurance following a generic hearing on the subject of efficiency. The actual costs of some insurers are clearly excessive. For example, as shown above, some large writers of Private Passenger Cars Auto Liability sell at expense levels twice as high as other large writers. Smaller insurers have an even larger range. The
mean of all insurers includes these excessive amounts. In a truly competitive market, the low cost provider should clear the market.

50. I suggest that serious consideration be given to establishing the efficient level of cost at the 70th percentile of efficiency for each of the following expense categories:

- Commission and Brokerage
- Other Acquisition
- General
- Unallocated Loss Adjustment (ALAE)

51. The 70th percentile of efficiency is not near the optimal efficiency level. In Massachusetts, the Department of Insurance has used, and the courts have accepted (381 Mass. 592; 411 NE 2nd 762), a "competition adjustment factor" to lower the mean expenses to reflect competitive forces.

52. The question of whether the Commission and Brokerage should be handled by looking at the industry as a unified one or splitting it into three industries (independent agency, dependent or "captive" agency and direct writer) is an important one. I strongly urge looking at this market as one market. Some insurers -- e.g., Allstate -- use different methods of selling under one roof. The consumer should be indifferent to the modus operandi of a specific insurer -- it is service level related to price that really matters. As indicated above, some of the most-efficient, lowest-priced insurers offer some of the best service.

53. Once the country-wide expenses have gone through the disallowance and capping procedures, they must be allocated to
California. The basis of allocation is important. Variable expenses are properly allocated by premium, but fixed expenses are not.

54. Unallocated loss adjustment expenses should be allocated based on losses, I believe. This is not exceptional in actuarial methodology.

55. I propose that other acquisition and general expenses be allocated on a per policy or per exposure basis. I believe that use of premiums should not be allowed because a state’s tendency to higher or lower insurance premiums due to claims is not shown to be correlated with higher or lower other acquisition and general expenses. Heat, light, the home office gardener, the president’s salary, etc., should be allocated on a flat, not a variable, basis.

56. Policyholder dividends are not to be counted as an expense in testing the Rollback levels.

I. Form 8 - Recapitulation of Key Findings

57. Form 8 is a simple recap of the major findings related to premium levels and savings attributable to Proposition 103’s Rollback provisions.

IV. Data Requirements

58. The Commissioner’s Application Requirements, together with the Annual Statements and Insurance Expense Exhibits in her possession, will contain most of the data required for her to complete these proposed protocols. Some additional data are necessary, however, viz:
To complete Form 1:

* Paid Loss Development
* Amounts of Penalties and Fines (including Bad Faith judgments/settlements/defense costs)

To complete Form 7:

* Disallowance amounts
* Policy counts (or exposures) for allocation purposes

59. Certain other missing items would be obtained or decided upon during the generic hearings.

60. The Commissioner can collect these items and undertake the completion of the form or ask insurers to fill out the forms as a temporary supplement to the Application only used for Rollback exemption purposes (i.e., not used after November 7, 1989).

V. Conclusion

61. The Rollback requires a unique test of the constitutionally required minimum premium. In my opinion, the Application forms promulgated by the Commissioner of Insurance are suitable, generally, for testing the more normal ratemaking of Proposition 103's prior approval regime (after November 8, 1989) but requires additional information and a different work up to test
exemptions to the Rollback. I have proposed detailed forms for
the Commissioner to use to make this test.

I declare under penalty of perjury that the foregoing is true
and correct.

Executed in Los Angeles, California, on July 12, 1989.

J. Robert Hunter, FCAS, MAAA
<table>
<thead>
<tr>
<th>Company</th>
<th>NAIC Number</th>
<th>Line of Insurance</th>
<th>Coverage</th>
</tr>
</thead>
</table>

**FORM I**

**Allowable Costs (Excluding Variable Expenses)**

<table>
<thead>
<tr>
<th>Losses Based on Latest Year Ended MM/YY</th>
<th>Losses Based on First Previous Year</th>
<th>Losses Based on Second Previous Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A) Losses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Total Limits Paid Losses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Allocated LAE Paid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Total Limits Paid Losses and ALAE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Total Limits Loss Development Factor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Developed Total Limits Incurred Losses and ALAE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Trend Factor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Total Trended Losses and ALAE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Mean Total Trended Losses and ALAE</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**B) Allowable Fixed Expenses**

|                           |                                     |                                      |
|---------------------------|                                     |                                      |
| 1 ULAE (from Form 7)      |                                     |                                      |
| 2 Other Acquisition (from Form 7) |                             |                                      |
| 3 General (from Form 7)   |                                     |                                      |
| 4 Trend Factor for Fixed Expenses |                                 |                                      |
| 5 Total Allowable Fixed Expenses |                             |                                      |

**C) Total Allowable Costs (Excluding Variable Expenses)**
### FORM 2

**Determination of Constitutionally Required Revenue From Premiums**

1. Rate of return on surplus required (pre-tax)  
2. Total allowable costs (from Form 1)  
3. Surplus required (from Form 5)  
4. Return on required surplus \((3) \times (1)\)  
5. Revenue Requirement \(\left(\frac{4}{2}\right)\)  
6. Income other than premiums:  
   A. Investment income (latest year actual)  
   B. Realized capital gains (latest 3-year average)  
   C. Miscellaneous income  
   D. Total  
7. California Tax Ratio  
8. [California] Commission and Brokerage Ratio (from Form?)  
9. Constitutionally required revenue from premium  
   A. Revenue requirements from premiums  
   B. Variable expense ratio  
   C. Total Revenue requirement
Calculation of Total Constitutionally Required Premium Revenues

1. Constitutionally required revenue from premiums for each line and company (from Form 2)

A. **Company A**

<table>
<thead>
<tr>
<th>Line 1</th>
<th>Line 2</th>
<th>Line N</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

B. **Company B**

<table>
<thead>
<tr>
<th>Line 1</th>
<th>Line 2</th>
<th>Line N</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

C. **Company C**

<table>
<thead>
<tr>
<th>Line 1</th>
<th>Line 2</th>
<th>Line N</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

D. **Company D**

<table>
<thead>
<tr>
<th>Line 1</th>
<th>Line 2</th>
<th>Line N</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

401
FORM 3 (Page 2)

2. Total constitutionally required revenue from premiums

A. Total constitutionally-required revenue from premiums for Company A $_______

B. Total $_______

N. Total constitutionally-required revenue from premiums for Company N $_______

3. Grand total (add individual totals for each company) $_______
<table>
<thead>
<tr>
<th>Group</th>
<th>Percent Increase Needed From Rollback Level of Proposition 103</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Total constitutionally required revenue from premiums for the group (from Form 3) $__________</td>
</tr>
<tr>
<td>2</td>
<td>Premium revenues at Proposition 103 rollback level (Form 6 -- Section E -- Col. 3) $__________</td>
</tr>
<tr>
<td>3</td>
<td>Exemption level justified from Proposition 103 rollback (line 1 - line 2) $__________</td>
</tr>
<tr>
<td>4</td>
<td>Percentage increase over Proposition 103 rollback level justified (line 3 / line 2) ________%</td>
</tr>
</tbody>
</table>
Calculation of Required Surplus

A. Group Ratio of Loss Reserves to Surplus
   1. Total group loss reserve at year end 1988 $__________
   2. Consolidated group surplus as regards policyholders at year end 1988 $__________
   3. Ratio of loss reserves to surplus
   4. Minimum allowable ratio

B. Company/Line Surplus
   1. Loss reserve $__________
   2. Surplus required (B1 divided by greater of A3 and A4) $__________
A. Rate Level History:

<table>
<thead>
<tr>
<th>Line/Coverage</th>
<th>Date</th>
<th>% Change</th>
<th>Line/Coverage</th>
<th>Date</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

B. Latest Year Total Limits Premiums Written:

<table>
<thead>
<tr>
<th>Line/Coverage</th>
<th>Premiums Written</th>
<th>Year Ended</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>MM/YY</td>
</tr>
</tbody>
</table>

Total $__________

C. Written Premiums at Current Rate Level:

<table>
<thead>
<tr>
<th>Line/Coverage</th>
<th>Written Premiums at Current Rate Level</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$</td>
</tr>
</tbody>
</table>

Total $__________

D. Written Premiums, Including All Premium Trend

1. Total for C above
2. Trend factor
3. Trended premium
### E. Premiums at 103 Rollback Level:

<table>
<thead>
<tr>
<th>Coverage</th>
<th>Premiums at 103 Rollback Level of November 8, 1987</th>
<th>Column (2) x 0.80</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

**Note:**
- Column (2) represents premiums at the 103 Rollback Level of November 8, 1987, multiplied by 0.80.
- The total is calculated by multiplying the premiums by 0.80.
### Recapitulation of Key Findings

#### Group Name

<table>
<thead>
<tr>
<th>Company Name</th>
<th>(a) Total Limits Premium at Current Rates</th>
<th>(b) Total Limits Premium at Prop. 103 Rates</th>
<th>(c) Total Limits Premium at Constitutionally Required Rate</th>
<th>(d) Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>B</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>&quot;</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>&quot;</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>N</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>Total</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
</tbody>
</table>

#### Line

<table>
<thead>
<tr>
<th>Line</th>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>2</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>3</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>4</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>5</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>Total</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
</tr>
</tbody>
</table>