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STATE OF MARYLAND
MARYLAND INSURANCE ADMINISTRATION
525 St. Paul Place, Baltimore, Maryland 21202-2272

To: **Property and Casualty Insurers**

Re: **Permissible Application of Underwriting Standards When Deciding Whether to Cancel, Refuse to Underwrite or Renew a Risk**

Date: **November 26, 2003**

Bulletin: **Property and Casualty 03-16**

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The final order issued by this Administration in *Insurance Commissioner for the State of Maryland v. Royal Insurance Company of America*, No. MIA-217-5/02 (8/26/02) (hereinafter "Royal") has occasioned numerous inquiries regarding the respective roles of underwriting standards and rating plans in the underwriting process. The purpose of this bulletin is to clarify the Administration's view as to the permissible application of underwriting standards by property and casualty insurers in deciding whether to cancel, refuse to underwrite or renew a risk.

I. THE STATUTORY STANDARDS

Section 27-501 of the Insurance Article circumscribes an insurer's ability to decline certain risks or categories of risk. Subsection (a) of that section states:

> (1) An insurer or insurance producer may not cancel or refuse to underwrite or renew a particular insurance risk or class of risk for a reason based wholly or partly on race, color, creed, sex, or blindness of an applicant or policyholder or for any arbitrary, capricious, or unfairly discriminatory reason.
>
> (2) Except as provided in this section, an insurer or insurance producer may not cancel or refuse to underwrite or renew a particular insurance risk or class of risk except by the application of standards that are reasonably related to the insurer's economic and business purposes.

Subsection (a)(1) prohibits discrimination in underwriting based on certain identified criteria. Section (a)(2) is broader and

> requires that all underwriting decisions of insurers . . . be made solely on the basis of a reasonable application to relevant facts of underwriting principles, standards and rules that can be demonstrated objectively to measure the probability of a direct and substantial adverse effect upon losses or expenses of the insurer in light of the approved rating plan or plans of the insurer then in effect.

Preamble, Chapter 752, 1974 Laws of Maryland.

Section 27-501(g) places the burden on the insurer “to show that the cancellation or refusal to underwrite or renew is justified under the underwriting standards demonstrated.”

II. The *Lumbermen’s* Decision

A critical inquiry under § 27-501 is whether the underwriting standard relied upon by an insurer in deciding whether to cancel, refuse to underwrite or renew a risk is reasonably related to the insurer’s economic and business purpose. That is a determination that must be made with reference to the insurer’s filed rating plan.

The Maryland Court of Appeals addressed that standard in *Lumbermen’s Mutual Casualty Company v. Ins. Comm’r*, 302 Md. 248 (1985). In *Lumbermen’s*, two related insurers non-renewed three policyholders, each of whom had more than one incident within a three year period (two accidents, three traffic violations, and two traffic violations, respectively). *Id.* at 259. Both insurers had rating plans on file that allowed surcharges to be imposed on any policyholder who had such incidents within a three-year period.

The insurers argued that the non-renewals were justified despite the available surcharges, because “the amount of the surcharge under the rating plan ‘does not compensate the company for the increased risk.’” *Id.* at 262. The Court of Appeals rejected that argument, stating:

> [t]he justification for cancellation or nonrenewal set forth in [§ 27-501(a)(2)] . . . does not encompass the situation where the gist of the insurer’s complaint is that its filed and approved rating plan, *covering the specific situation involved*, is inadequate. We do not believe that the Legislature intended that a proceeding under [§ 27-501] could be converted into a rate case.

Id. at 267 (emphasis added).

The Court stated that “[i]n the instant cases, instead of applying an underwriting standard ‘in light of the approved rating plan,’ the insurers have attempted to attack the approved rating plan.” *Id.* The Court concluded that

> If the two insurers in these cases desired greater surcharges for insured drivers having more than one traffic violation or accident in a three year period, they could have applied for such modification of their rating plans.

> . . . Or if the insurers decided that they did not wish to insure such risks, they could similarly have sought to modify their rating plans by deleting this classification of risks. But, in our view, proceedings under [§ 27-501] were not intended to encompass challenges to the adequacy of rating plans.

Id. at 269.

Lumbermen's confirms that the decision not to write a risk must be based on underwriting standards that are reasonably related to the insurer's economic and business purpose. *Lumbermen's* concludes, however, that there is no economic justification for the refusal to write a risk based on a specific risk characteristic that is expressly addressed, and accounted for, in the insurer's filed rating plan.

Since *Lumbermen's*, the Court of Special Appeals has approved of the non-renewal or cancellation of insurance policies based upon underwriting standards where the risk characteristic addressed by that standard is not expressly included in the insurer's rating plan. These cases have dealt with circumstances in which the insured misrepresented material facts in its application or falsified records.

- *Miller v. Ins. Comm'r*, 70 Md. App. 355, 370 (1987) (insurer's cancellation because of material misrepresentation by the insured did not violate § 27-501(a); *Lumbermen's* should not be read "as authority for the proposition that an underwriting standard providing for cancellation of a policy obtained by material misrepresentations is not reasonably related to the insurer's economic and business purposes").
- *Mirkin v. Medical Mutual Liability Ins. Soc. of Md.*, 82 Md. App. 540, 551 (1990) (cancellation of policy for falsification of records was reasonably related to economic and business purposes and did not need to be justified by statistics because "[t]here are obviously some underwriting standards whose fairness cannot be demonstrated through statistics").
- *Erie Ins. Co. v. Ins. Comm'r*, 84 Md. App. 317 (1990) (cancellation of policy complied with § 27-501(a)(2) where based upon applicant's misrepresentations).

III. The MIA's Interpretation and Application of *Lumbermen's*

Lumbermen's involved a specific and express conflict between a filed rating plan and underwriting standards. Under *Lumbermen's*, if the rating plan expressly addresses and identifies a rate for a particular risk characteristic, the insurer cannot cancel, refuse to underwrite or renew a risk based on that very characteristic.

The question has arisen as to whether the final orders issued by the MIA in *MIA v. Medical Mutual Liability Ins. Soc. of Md.*, MIA-96-2/01 (6/12/02) (hereinafter "Kijak") and *Royal* will be read to go beyond the holding of *Lumbermen's* and preclude the use of any underwriting standard that is not expressly incorporated into a rating plan.

Kijak characterized the *Lumbermen's* decision as holding "that, under § 27-501, an insurer's underwriting standard *could not be more restrictive than what was permitted* under a filed rating plan." *Kijak*, at 47 (emphasis added). While *Kijak* stated *Lumbermen's* broadly, it actually dealt with a direct conflict between an underwriting standard and a rating plan of the same variety that was addressed by the *Lumbermen's* Court. In *Kijak*, the filed rating plan had a surcharge that applied to any physician who accumulated 10 "evaluation points," while the underwriting standard used to cancel the complaining physician's policy prohibited the renewal of "insureds in a low-risk specialty who had ten (10) evaluation points with an open claim reserved for more than $250,000." Because the exact risk characteristic for which the policyholder was being nonrenewed had been expressly addressed and accounted for in the carrier's rating plan, *Kijak* fell squarely within *Lumbermen's* and merely applied the rule expressly articulated in that case.

Royal concluded, among other things, that the insurer in that case violated § 27-501 when it refused to renew a blanket property insurance policy on the grounds that its post-9/11 underwriting guidelines required a terrorism exclusion in all policies, limited coverage to $100 million per occurrence, and prohibited policies with "blanket limits." *Royal* concluded that those new underwriting guidelines could not be used to nonrenew the policy. While a key element of that determination was the failure of Royal to have revised its policy forms to include a terrorism exclusion, the *Royal* Order does state: "[b]ecause Royal cannot use its underwriting guidelines to refuse to insure a risk for which it has an available rate, Royal's new coverage limits do not justify its refusal to renew the State's Policy." *Royal* at 56.

This language has created confusion among insurers and policyholders. This bulletin is intended to dispel that confusion and to clarify the MIA's position.

Royal does not stand for, and will not be read to stand for, the proposition that no underwriting standard may be utilized to cancel or to refuse to underwrite or renew a risk unless the risk factor that is the subject of the standard is expressly eliminated from the insurer's rating plan.

Under § 27-501, an insurer's decision to cancel or to refuse to underwrite or renew a risk must actually be based on uniformly applied underwriting standards: a) that exist; b) that are not discriminatory in violation of § 27-501(a)(1); and c) that can be demonstrated to be reasonably related to the insurer's economic and business purpose. *Lumbermen's* instructs that an underwriting standard is not reasonably related to the insurer's economic and business purpose as a matter of law if that standard leads to the rejection of a risk based on a characteristic that is expressly identified and provided for in the insurer's filed rating plan. If, as in *Lumbermen's*, the insurer has expressly accounted for, and filed a rate for, a particular risk characteristic as part of its rating plan, that insurer cannot later reject a risk based on that exact same characteristic. Thus, *Lumbermen's* adds to the §27-501 analysis the requirement: d) that the underwriting standard utilized by the insurer not be in conflict with a rating modifier, rule, surcharge or other factor expressly included in the insurer's filed rating plan.

If a carrier cancels or refuses to underwrite or renew a risk, and a complaint is filed with the Administration challenging that action under §27-501, the Administration will investigate the basis of the insurer's underwriting decision and will address the specific concerns identified in the complaint. In doing so, the Administration will determine whether the risk characteristic underlying the insurer's rejection of the risk is expressly addressed in the insurer's rating plan. If so, the insurer's reliance on that risk characteristic will be found to be a violation of §27-501(a)(2) as a matter of law.

To summarize, this Administration does not take the position that every risk characteristic that an insurer may employ to determine eligibility for coverage must be accounted for within an insurer's filed rating plan, such that the failure to expressly exclude a particular characteristic for a particular rating classification is presumed to be an acceptance of that characteristic for all times, for all risks, and in all circumstances. Underwriting standards that establish acceptable risk characteristics may be adopted and applied by insurers as long as those standards meet the requisites of §27-501. Risks may be declined on the basis of such standards so long as the specific characteristic addressed by the standard is not expressly addressed and provided for within the applicable rating classification within the insurer's filed rating plan. It is not necessary for an insurer to withdraw an entire rating classification or to file a specific rating rule for each specific risk characteristic that it elects to address as part of its underwriting process.

Questions regarding this bulletin should be directed to: Fred Santiago, Supervisor of the P&C Unit at 410-468-2317 or fsantiago@mdinsurance.state.md.us.

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