

DATE: 10/07/04 (nunc pro tunc 09/15/04)

Docket No. C2004-03

**Commonwealth Automobile Reinsurers’
Proposed Changes to the Rules of Operation
Implementing a Limited Servicing Carrier Plan
Docket No. C2004-03**

CORRECTED ORDER

This Corrected Order corrects a misstatement, indicated by *, at page seven of the Order filed on September 15, 2004.

I. Introduction

On June 17, 2004, Commonwealth Automobile Reinsurers (“CAR”) submitted to the Commissioner of Insurance (“Commissioner”) an extensive set of proposed changes (the “Proposal”) to the CAR Rules of Operation (“Rules”), relating to the residual market for commercial motor vehicle insurance. The Proposal would, in essence, implement a limited servicing carrier (“LSC”) program for ceded commercial motor vehicle policies effective on and after January 1, 2006, under which a limited number of carriers would be selected under a bid process to service all ceded commercial business. The Proposal included amendments to Rules 2, 6, 11, 13, 14, 16, 17, and 18. A hearing notice on this Proposal issued on July 14, scheduling a hearing for August 10. At the hearing, the majority of speakers, individuals representing CAR, the Property Casualty Insurers Association of America, the Massachusetts Association of Insurance Agents (“MAIA”), Pilgrim Insurance Company (“Pilgrim”), Chubb Insurance Companies, St. Paul Travelers Insurance Co., Liberty Mutual Group, and the Massachusetts Insurance Federation, spoke in support of the Proposal. Representatives of Commerce Insurance Co. (“Commerce”) and Arbella Mutual Insurance Co. (“Arbella”) spoke against the Proposal. At the

conclusion of the hearing, the record was left open until August 17 for the submission of additional written statements. Two such statements were submitted.

II. Background

CAR, which is established pursuant to G.L. c. 175, §113H, is responsible for the operation of the residual market for motor vehicle insurance in Massachusetts. The CAR Plan of Operation (“Plan”) allows CAR to promulgate rules which, following approval by the CAR Governing Committee, are then submitted to the Commissioner for her review and approval. The rule changes which are the subject of consideration in this proceeding were submitted for review contemporaneously with other extensive changes to the CAR Rules pertaining to the residual market for private passenger automobile insurance. As the proposals for private passenger motor vehicle residual market and commercial motor vehicle residual market present different issues, CAR made separate submissions, and the matters have been heard and are being considered separately. The proposed Rule revisions relating to the residual market for private passenger motor vehicles were considered at a hearing held July 22, and an order issued August 27 (“August 27 Order”) remanding that proposal to CAR (See, *Commonwealth Automobile Reinsurers Proposed Changes to the Rules of Operation, C2004-02*).

III. Summary of Amendments

Throughout the eight Rules that are revised in this Proposal, CAR replaces all references to “All Other Motor Vehicle” business with “Commercial” business, distinguishes private passenger Exclusive Representative Producers (“ERPs”) from commercial ERPs, and modifies the Rules to distinguish the specific requirements and responsibilities of a private passenger Servicing Carrier and a commercial Servicing Carrier. The changes specific to Rules 2, 6, 11, 13, 14, 16, 17 and 18 are summarized below.

Rule 2 - Definitions

The definition of an “Exclusive Representative Producer” included in the CAR Proposal specifies the differences between a private passenger and a commercial Exclusive Representative Producer. Additionally, the Rule specifies that the commercial ERP, who may be a licensed producer appointed by CAR for private passenger motor vehicle insurance, or who may have a voluntary relationship with a CAR member for commercial motor vehicle insurance, must also be appointed by CAR to a Servicing

Carrier for the purposes of writing commercial ceded business. Rule 2 is also amended to limit the authority of a "Representative Producer" to the certification of private passenger motor vehicle policies.

Rule 6 – Coverages

The CAR Proposal modifies Rule 6 to provide that, for commercial motor vehicle policies effective January 1, 2008, coverage limits for Bodily Injury Liability will be \$500,000/\$500,000 per person and per accident; Property Damage Liability limits will be \$250,000; and combined single limit for Bodily Injury and Property Damage Liability will be \$500,000 per accident. For policies effective December 31, 2007 and prior, the Proposal would retain the current policy limits of \$1 million/\$1 million per person and per accident for Bodily Injury Liability, \$500,000 for Property Damage Liability, and combined single limit for Bodily Injury and Property Damage Liability of \$1 million per accident.

Rule 11 – Assessments and Participation

The CAR Proposal adds a section which specifically addresses the calculation of commercial participation ratios for policy years 2006 and later. Most significantly, these changes provide that: 1) commercial participation ratios will be based upon retained market share; 2) ceded premium will not be included in the commercial participation formula; and 3) the administrative expense calculation will not include commercial ceded premium with policy effective dates of January 1, 2006 and later. Additionally, the Proposal eliminates the eight-year buyout provision for those companies electing to withdraw from the commercial market, based on CAR's assessment that, under the new commercial participation formula, such a provision would be unenforceable.

The CAR Proposal also makes a series of clarifying amendments to Rule 11. Rule 11.A has been modified to specifically state that underwriting results for those companies that do not exceed CAR's established statistical reporting thresholds (and therefore are not required to report statistical data to CAR) will be determined using the company's Massachusetts Annual Statement data. Additionally, the Proposal amends the text of Rule 11 to use a consistent citation form.

The CAR Proposal specifically noted that the specifics of exclusions and the K factor for policy year 2005 were deliberately omitted from the Proposal as CAR's committees would be addressing these issues in the near future.

Rule 13 – Servicing Carrier Requirements

The CAR Proposal identifies distinct requirements and responsibilities for private passenger and commercial Servicing Carriers. First, the Proposal specifies different procedures for appointment of the two types of servicing carriers, and, for commercial servicing carriers, sets forth the new procedures to be used for policies effective January 1, 2006 and later. Under the Proposal, the Governing Committee will appoint a limited number of servicing carriers. As revised, Rule 13 would also establish a deadline for the appointed commercial Servicing Carriers to establish contracts with the appointed ERPs. The CAR Proposal also amends the requirements for commercial servicing carriers to provide that eligibility is not contingent on maintaining a voluntary book of business. The Proposal sets forth a subscription methodology specific to commercial Servicing Carriers, which disallows two-party agreements with an ERP of a commercial Servicing Carrier, but permits three-party agreements allowing an ERP to be transferred from one servicing carrier to another.

Rule 14 – Representative Producer and Exclusive Representative Producer Requirements

The CAR Proposal amends Rule 14 to provide that, as of January 1, 2006, any licensed producer who has not been appointed to one of the selected servicing carriers as a commercial ERP may seek such an appointment, and defines the eligibility requirements for such an appointment. Production criteria for commercial ERPs are as follows: within 12 months after the appointment date, a minimum book of business of \$10,000 in commercial motor vehicle written premium; within 24 months, a minimum book of business of \$20,000; and within 36 months, a minimum book of business of \$30,000.

Rule 16 – Terminations

The CAR Proposal amends Rule 16 to provide that for commercial business, a Servicing Carrier must provide one year's notice of a voluntary termination of association as a servicing carrier, and specifies the procedure for terminating a Servicing Carrier, and determining an equitable distribution of its business.

Rule 17 – Expense Allowances to Servicing Carriers on Representative Producers and Exclusive Representative Producers

The CAR Proposal adds a new subsection, Rule 17.B.1.a., which specifies the calculation of commercial ceding expenses for policy years 2006 and later. Most significantly, commercial Servicing Carriers will be reimbursed for premium taxes and commissions based upon the approved CAR rate filing for the corresponding policy year, and for “Other Expenses” (including ULAE expenses, Other Acquisition Expenses, and Company and General Expenses), Servicing Carriers will be reimbursed according to the allowance determined through the LSC bid review and selection process. The CAR Proposal deletes in its entirety the miscellaneous expense allowance section of Rule 17.

CAR notes in its filing that all aspects of cession limitations, including excluded classes, cession limitation percentages and the expense allowance reduction penalties for exceeding the established percentages will not apply to policy years 2006 and later. Although CAR noted that the cession limitation would continue to apply to commercial motor vehicle policies for prior policy years, it also stated that the specifics of exclusions and the cession limitation for policy year 2005 were deliberately omitted from the Proposal as CAR’s committees intend to address these issues in the near future.

Rule 18 – Commissions

The CAR Proposal amends Rule 18 to distinguish, for ceded commercial business, commissions paid to those ERPs operating under the American Agency System from those who are not.

IV. Discussion and Analysis

All who offered comment at this proceeding agreed that changes to the current commercial insurance residual market are necessary. Notwithstanding this agreement, a division exists within the industry regarding whether the CAR Proposal represented the optimal method for improving the operation of this market.

Opponents of the Proposal centered their concerns on the possibility that the Proposal could result in a larger residual market deficit, and that it could cause significant market disruption to insureds. John V. Kelly, Assistant Vice President of Automobile Services at Commerce commented that, depending on the number of companies appointed as LSCs, up to 50 percent of the residual market may need to change carriers. He further opined that the minimum production criteria established in the Proposal may

force the termination of small producers. Commerce also contended that eliminating penalties for ceding business will cause the residual market to grow. It additionally argued that having a limited number of servicing carriers, who seek a profit for servicing the business, will lead to increased CAR ceding expenses for the commercial residual market. Commerce additionally noted that commercial carriers would be able to immediately write themselves out of the market without a penalty for withdrawal, notwithstanding its acknowledgement that the current market is attractive, thereby making such withdrawal unlikely. It argued that because no minimum voluntary presence is necessary, the LSC might have no financial stake in the final results and, if their claims handling is deficient, no share in the costs. Next, Commerce argued that the decrease in the cedeable coverage limits, as of January 1, 2008, will present problems for insureds unless a viable excess market develops. Commerce argues that Rule 11 does not address the situation where all writings are ceded, and no appropriate participation ratio can be calculated.

John Kittell, Senior Vice President of Arbella, noted that the commercial motor vehicle residual market in Massachusetts is so large that it represents more than one third of the involuntary business in the United States. He stressed that the size and growth of the residual market should be a primary focus of this reform effort. Arbella objects to the Proposal primarily on the basis that it will not fully address those concerns, and that, ultimately, the residual market will increase rather than decrease. It focused on the concern that without careful alignment of financial incentives, such as a requirement that the LSC be a voluntary carrier and thus have a stake in the ultimate results of the residual market, the Proposal will be ineffective.

Those testifying in support of the Proposal acknowledged that opinion was divided within the industry, but each concluded that the Proposal would provide a workable solution, and one which would permit companies with greater resources to devote to commercial business, and more specialized expertise in that market, to be responsible for servicing that business. Ralph Iannaco, President of CAR, testified that at its July 2002 meeting, the CAR Commercial Lines Committee, in recognition of the growing concern about commercial market issues, established the Commercial Automobile Subcommittee ("Subcommittee") to address this market. The Subcommittee included four producer representatives, and seven companies, with a combined

commercial market share of over 58 percent of the market. Mr. Iannaco included with his testimony a listing of the meetings held by the Subcommittee, and the numerous alternative proposals the Subcommittee considered, including an expansion of excluded classes and a reduction in the K-factor. The Subcommittee recommended the establishment of a limited servicing carrier program, under which servicing carriers would be selected under a bid process to service all ceded commercial business. Mr. Iannaco testified that the Subcommittee based this recommendation on its conclusion that this process would, overall, result in a more efficient operation of the residual market by consolidating operational and fraud control functions in carriers with expertise in commercial risks, and that appointing all producers to a limited number of Servicing Carriers would eliminate producer access issues. The Subcommittee also concluded that this program would address concerns of smaller commercial carriers by eliminating the requirement that they be appointed as Servicing Carriers.

Michael Trovato, Executive Vice President and Treasurer of CAR, added to Mr. Iannaco's testimony, stating the LSC program was designed to reduce the number of commercial Servicing Carriers to no ***fewer** than five, with selection based on criteria reflective of the company's ability to service these risks; to provide a more level playing field for voluntary agents; prevent the growth of the residual market by providing more opportunities for voluntary placement of risks, and keep deficits from growing through improved loss control and underwriting. Mr. Trovato testified that the Subcommittee recognized that while there would be some initial market disruption due to the transition to a new system, the long-term stability of the market would be greatly enhanced.

All other supporters of the Proposal, whether speaking on behalf of producers or insurers, agreed with CAR's assessment that the CAR Proposal would facilitate the depopulation of the commercial residual market, reduce the operating costs of the commercial residual market, reduce loss ratios, and afford voluntary producers access to the commercial market. All agreed that the process followed by CAR had permitted consideration of a full range of alternatives, and, that of those offered, the final CAR Proposal represented the best single alternative.

The arguments in opposition to the approval of the CAR Proposal are not persuasive, and are outweighed by the testimony offered in support of it. Although any change to the operation of the residual market may result in short-term disruption, the

long term goals of reducing costs and expenses support the reform effort that CAR has presented in this Proposal. The need for reform is clear: The residual market for commercial motor vehicle insurance is, proportionately, the largest in the nation, despite the fact that it is not currently operating at a deficit. CAR engaged in a thorough, deliberative process to reach this Proposal, carefully considering, in a process that spanned two years, numerous alternative proposals for reform. We recognize that there are risks inherent in the adoption of any reform effort, but find that the proposal as offered provides incentives for insureds and producers to seek voluntary coverage, for residual market risks to be written by carriers with expertise in a specialty market, and for an equitable distribution of risks. Further, the important goal of reducing insurance fraud will be furthered by these changes. For these and all the reasons articulated by those who testified in support of it, we find the Limited Servicing Carrier program implemented by the Proposal to be reasonable, and that it should be approved.

The *August 27 Order* instructed CAR to perform a comprehensive review of the Rules and to make appropriate revisions to correct typographical errors and ensure that the language is consistent with current law. We anticipate that as the two Proposals address many of the same Rules, that CAR will implement these technical changes throughout its Rules. At the hearing on this Proposal, CAR also agreed to certain other technical corrections, including, for example, the substitution of the phrase “Exclusive Representative Producer” for “Representative Producer” on page 24. Subject to these technical corrections, the rule revisions in the CAR Proposal are *approved*.

This Corrected Order is issued nunc pro tunc September 15, 2004.

Dated: October 7, 2004

Stephen M. Sumner
Presiding Officer