
**Commonwealth Automobile Reinsurers
Proposed Revisions to the Performance Standards
For the Handling and Payment of Claims by
Servicing Carriers
Docket No. C2005-03**

Procedural History

Pursuant to G.L. c. 175, §113H, Commonwealth Automobile Reinsurers (“CAR”), as the entity operating the residual market mechanism established under that statute, must file, at least once every two years, performance standards relating to the handling and payment of claims by servicing carriers. Those performance standards must be approved by the Commissioner of Insurance (“Commissioner”). On February 16, 2005, CAR filed proposed modifications to the current standards that had been approved on October 30, 2003. A notice of hearing was issued on June 22, scheduling a public hearing on the matter for July 15. At that hearing, Kathleen H. Devericks, Chair of CAR’s Claims Advisory Committee, presented testimony on behalf of Valerie Gedziun, CAR’s Vice-president for Claims. Cara Blank, FCAS, MAAA, an actuary with the State Rating Bureau at the Division of Insurance (“SRB”) and Leonard Fisher, a licensed insurance producer, also made statements. At the close of the hearing, the record was left open until July 22. On July 19, CAR requested that the docket remain open until July 29 to permit it to submit a response after a meeting of the Claims Advisory Committee. Its request was allowed. CAR filed an additional statement on July 28, and the SRB submitted additional testimony on July 29 in the form of an affidavit, with exhibits, from Ms. Blank.

Summary of the Proposed Changes

CAR states that, in response to an April 29, 2004 directive from the Commissioner, it has expanded the performance standards to include industry best practices and to increase the emphasis on evaluating the handling of bodily injury claims. Further, in compliance with decisions from the Commissioner on proposed revisions to the CAR Rules of Operation (“CAR Rules”), it has incorporated into its proposal standards and performance measures promulgated by the National Association of Insurance Commissioners (“NAIC”). CAR has revised three appendices to the Performance Standards and added two that identify, respectively, references in the proposed standards to industry best practices and to the NAIC standards.

The summary outlines changes that CAR has made to five areas of the Performance Standards that address specific aspects of claim handling. Section I, previously titled Auto Body Payments, now addresses Auto Physical Damage and Property Damage Liability Claims. Section II, which formerly defined fraudulent claims, now addresses Bodily Injury and Uninsured/Underinsured Motorist Claims.¹ Section III relates to No-Fault Personal Injury Protection Benefit Claims, and Part IV to Voluntary/Ceded Claim Handling Differential.² Part V addresses claim handling expenses. CAR also describes changes to the Measurements and Penalties section of the Performance Standards, pointing out that the penalties in the current standards have been retained.

Summary of Statements at the July 15 Hearing

1. CAR

Ms. Gedziun’s statement, presented by Ms. Devericks, summarized CAR’s review process following the Commissioner’s April 29, 2004 letter and her subsequent decisions on revisions to the CAR Rules, and noted that the CAR Governing Committee had unanimously approved the revised standards. It identified several best practices that had been incorporated into the proposed standards, including added emphasis on: 1) review of policy information when a claim is made and appropriate notification to the company underwriting department; 2) setting timely, reasonable reserves in accordance with documented company policy; and 3) improved litigation management, including review of

¹ The definition is now found in Appendix E to the Performance Standards.

² CAR notes that no changes have been made to Section IV.

legal bills and settlement of cases within a company's approved evaluation range. Her statement also pointed out that the new standards require servicing carriers to provide training to producers on claim reporting and fraud recognition, and reported that the Claims Advisory Producer Training Subcommittee is developing a fraud training seminar for producers.

Ms. Gedziun commented that CAR had compared NAIC standards for claim settlement practices to CAR Rule 10, Claim Practices and the Performance Standards. She noted that the NAIC Standards are based on two model regulations, while in Massachusetts unfair claim settlement practices are defined in G.L. c. 176D. CAR's comparison, she stated, indicated that its standards include more stringent requirements than those of the NAIC.

Addressing benchmarks and measurements for evaluating performance, Ms. Gedziun noted that the proposed standards set benchmarks at levels consistent with the NAIC error tolerances, while measurements for glass claims, reinspections and the Insurance Claim Payment Intercept Program ("ICPIP") are set at Massachusetts statutory levels. In light of the added standards and the increased compliance rate, CAR recommends no change to the current penalties. Ms. Gedziun also pointed out that the CAR Claim Department file review procedures have been revised to incorporate a sample selection technique that follows the NAIC Market Conduct Examiners Handbook. CAR will also modify its use of a questionnaire to provide background information on a company's claim handling programs.

On behalf of the Claims Advisory Committee, Ms. Gedziun requested that the Commissioner allow a 60-day implementation period following approval of the revised Performance Standards, and allow compliance measurements to be based on claim activity moving forward from the implementation date. She noted that the latter would allow CAR to evaluate compliance on existing claims. Finally, Ms. Gedziun reported three editorial changes to the Performance Standards as submitted in February.

2. The SRB

Ms. Blank, on behalf of the SRB, asserted that the CAR's proposed Standards do not fully address the findings and conclusions in the 2004 report prepared by the Tillinghast business of Towers Perrin based on its 2003 independent examination of CAR.

In particular, she stated, they do not sufficiently monitor claim handling quality, provide for a quantitative assessment of claim outcomes on closed claims to be competitive with industry practices, or improve the emphasis on evaluating the substantive components of handling bodily injury claims.

Ms. Blank stated that the structure of the Massachusetts private passenger automobile market fosters an environment in which companies are motivated to handle claims from policies ceded to CAR differently from policies that are not ceded [*i.e.*, “voluntary” policies]. She noted that companies have testified that allocation to insurers of residual market costs based on pooled premiums, losses and expenses creates a disincentive for companies to apply the same qualitative standards to ceded as voluntary policies, because ceding alters the cost-benefit trade-off between claim investigation and final settlement. Ms. Blank further commented that, to the extent that policies issued to some sectors of the population are ceded more frequently than those issued to other sectors, relaxed handling for ceded claims creates an environment that is susceptible to claims abuse by some insureds. She noted that 30 percent of all ceded policies are from seven cities in the Commonwealth, whose aggregate population is eleven percent of the total population, and that almost 62 percent of the ceded population has a driving record with at least one accident or violation. Finally, Ms. Blank stated, because of the ratesetting methodology in Massachusetts, a significant portion of the cost of less aggressive claim handling on ceded policies is shifted to drivers in areas where fewer policies are ceded.

Ms. Blank observed that the proposed performance standard relating to differentials between the handling of claims on ceded and voluntary policies is unchanged from the current standard, which states that: 1) there will be no difference in claim handling between the two groups of policies; and 2) other than required statistical coding, claim files will include no evidence on whether the policy is ceded. Ms. Blank pointed out that the standard includes no method for measuring performance relating to a claim handling differential. As one test of possible differences in claim handling, she measured the change in the average losses per insured vehicle over a seven-year period.

Ms. Blank stated that, in policy year 2003, approximately seven percent of all insured vehicles were ceded to CAR and that, between 1997 and 2003, the average annual injury loss per insured vehicle increased 48 percent for claims on ceded policies and one

percent for claims on voluntary policies.³ These data, she testified, show an eight percent annual expected rate of increase in the average loss per vehicle for ceded policies compared to one percent for voluntary policies. During the period from 1997 to 2003, she further noted, average bodily injury claim frequency rose 65 percent for ceded policies compared to eight percent for voluntary policies, resulting in a 5.6 ratio of ceded claims frequency to voluntary claims frequency. Similarly, Ms. Blank stated, in that same time period the average frequency for personal injury protection (“PIP”) claims increased 32 percent for ceded policies, but decreased 15 percent for voluntary policies. A higher average claim frequency for ceded claims is to be expected, she explained, because drivers ceded to the pool are more likely to have poor driving records. In contrast to frequency, Ms. Blank stated, severity per claimant is relatively similar on ceded and voluntary bodily injury claims, and is roughly 20 percent higher on ceded PIP claims.

Ms. Blank stated that an examination of the ratio of bodily injury claims frequency to that of property damage liability claims provides a measure of the number of claims that arise from an accident involving a single vehicle. In the seven-year time period, she testified, the number of bodily injury claims generated by a single property damage claim increased 36 percent for ceded policies and one percent for voluntary policies. For PIP coverage, the number of claims per property damage claim increased 8 percent for ceded policies and decreased 20 percent for voluntary policies. Ms. Blank distributed a chart showing changes in the ratio of bodily injury to property damage claims for the seven cities where many policies are ceded to CAR. She stated that over 50 percent of the losses incurred in those cities are ceded to CAR, compared to approximately 20 percent of incurred losses that are ceded from the rest of the state. She testified, as well, that in the seven cities more claimants are represented by attorneys, and that the average number of injury claims per car for claimants alleging sprains or strains from a motor vehicle accident, who are represented by counsel, is four or five times higher than the corresponding frequency for other claimants with strains or sprains, regardless of where they live.

³ In her post-hearing written testimony, Ms. Blank stated that the increase for claims on voluntary policies was two percent.

Ms. Blank further noted that in Massachusetts 67 percent of all injury claimants treat primarily with a chiropractor, physical therapist or alternative provider, and that 46 percent of Massachusetts PIP claimants use a chiropractor as their primary provider. The statewide average number of visits to a chiropractor is 20 per claimant, and over 35 percent of claimants treating with chiropractors are seen more than 20 times.

Ms. Blank testified that the sustained growth of injury claims on policies ceded to CAR indicates that claims management for the residual market pool differs from that for voluntary policies. Payment of over 50 percent of losses in the seven cities on policies issued to approximately 20 percent of the vehicles in those cities, she stated, suggests a distinct difference in the claim handling for ceded policies. She noted, as well, that the early results of a fraud task force initiated in the city of Lawrence showed a 68 percent reduction in initial claims for personal injury in the first nine months of 2004 compared to the same period in 2003.

Ms. Blank asserted that the data strongly suggest that CAR's historic emphasis on task measures that relate principally to prompt handling and appraisal criteria for first-party physical damage and PIP claims prevents it from identifying practices that facilitate overpayment of bodily injury claims. Further, she noted the incentive to buttress claims exists throughout the state, not just in urban areas. The systematic overpayment of claims on ceded policies, however, increases the cost of insurance for all drivers.

Addressing the penalties imposed by the CAR Standards, Ms. Blank commented that they impose few penalties for non-compliance. She noted that the proposed standard adds a sentence to the section on "Minor Noncompliance" that states that a finding of minor noncompliance will not result in a warning or a penalty. The CAR annual report for 2004 reported that no insurer was fined for noncompliance. Based on her review of individual company data, Ms. Blank concluded that significant differences exist among company claim handling and agency management practices that have a noticeable impact on the financial deficit of the residual market. She therefore recommended, first, that the Commissioner consider modifying the proposed Performance Standards by directing CAR, with the help of an independent outside consultant, to develop an objective, quantifiable means of evaluating all claims outcomes, including bodily injury claims, according to measurable performance standards. Such measures, she stated, should include "leakage"

as that term is used in industry best practices.⁴ Second, Ms. Blank recommended that CAR, instead of waiting for a company to fix problems identified in an audit, develop meaningful and objectively determined adjustments to a company's deficit share and apply them in the year in which the audit is performed.. Again, she suggested that the adjustment be developed and proposed by an independent third party.

The Post-Hearing Submissions

1. CAR

CAR's July 28 submission responded to Ms. Blank's specific criticisms and recommendations and requested that the Commissioner approve its proposed performance standards. On the matter of standards for handling bodily injury claims, CAR pointed out that comparing the proposed Standards to industry best practices shows that ten claims standards have been added in the best practices areas, including litigation management. Regarding the issue of "leakage" and industry best practices, CAR asserted that there is no single standard procedure for evaluating such leakage and that, to its knowledge, such programs are all company-specific. It stated that it is unaware of any program that would extend across multiple companies or of a universal application that could be used to establish leakage for an entire industry. Further, CAR asserted that it addresses leakage in its reviews by quantifying whether a file complies with the measurements section of the standards and that its worksheets and review summary provide a narrative explaining the findings. Its examiners address hard evidence of overpayment such as missed deductibles or payments on bodily injury claims that do not reach the threshold. CAR also uses quantitative statistical reports to compare individual carriers' costs as shown by the file reviews and to determine whether a carrier is settling claims in line with its peers.

CAR reported that the Claims Advisory Committee, in the development of the performance standards, discussed the question of leakage. Several carriers, it stated, have leakage programs in place, and some have invested in programs such as Colossus and ISO Claims Advisor to ensure consistent evaluation and settlement of bodily injury claims. Those programs and procedures, CAR commented, are used on voluntary and ceded claims, as well as for claims in other states. It asserted that requiring servicing carriers to

⁴ In her post-hearing written testimony, Ms. Blank defined "leakage" as a best practice that addresses the amount by which individual claim payments differ from established targets or ranges.

follow other guidelines for settlements on ceded claims would lead to a difference in the handling of ceded and voluntary claims, in violation of the performance standards and the statute. CAR also expressed concern that it may become a party in third party lawsuits.⁵ For those reasons, it stated, the proposed standard on bodily injury claims settlements requires that carriers have a settlement evaluation plan and that settlements should be within the approved range.

In response to Ms. Blank's comment that the CAR's proposal does not change the performance standard for the voluntary/ceded claim handling differential, CAR asserted that the standard reiterates the requirement in G.L. c. 175, §113H that audits shall be conducted "in order to determine whether there is a difference in claim handling between policies insured voluntarily and those insured or reinsured by the plan." The standard, CAR stated, "can't be said any more simply or clearly," and therefore there is no need to change it.

Responding to Ms. Blank's statements that sustained growth of injury claims on policies ceded to CAR and payment of over half the losses in seven cities on policies issued to roughly 20 percent of the vehicles insured in those cities demonstrate a difference in claim handling on ceded policies, CAR asserted that its audits have never found any evidence of such a difference. It pointed out that its audits require an explanation from any carrier that identifies that a claim is on a ceded policy. CAR noted that its examiners, in 2004, looked at 2688 files, of which 68 percent were claims on ceded policies and 32 percent on voluntary policies. The examinations, it stated, are mostly conducted at company claims offices, adding that the same staff handles both voluntary and ceded claims and that in many companies the adjusters do not know which policies are ceded. CAR asserted that any procedures or instructions to limit cost containment on ceded claims would be evident in the files.

With respect to the number of claims that arise from the seven cities identified by Ms. Blank, CAR commented that a greater frequency of accidents is to be expected in those densely populated areas. Success of the task forces established by the Insurance Fraud Bureau ("IFB") in Lawrence and elsewhere in reducing claims is, CAR concluded, a positive indication of cooperation among servicing carriers, the IFB, and prosecutors.

⁵ CAR did not explain the basis for its concern.

CAR asserted that the claim files do not show a difference in handling ceded claims but instead show that most carriers have instituted special programs for files that meet certain criteria. One of those programs, Low Impact-Soft Tissue (“LIST”) refers to claims where there is minimal impact but the claim is for sprain and strain or multiple injuries. Such claims are targeted for handling, CAR stated, based on the circumstances of the accident and include both voluntary and ceded files. CAR noted that many of these accidents occur in the seven cities, that they receive increased scrutiny through referrals to SIUs, and that its file reviews show that aggressive claim handling mitigates the damages in these claims. In further support of its position, CAR referred to statistical information reported to it that shows that the average cost of BI ceded claims was less than the average loss on voluntary claims. It stated that when the new standards are approved, it will incorporate in its annual report additional comparisons of voluntary and ceded results on the new measurements.

CAR disagreed with Ms. Blank’s statement that its reviews historically emphasize task measures, commenting that its 2004 Annual Report evaluates both quantitative and qualitative standards.⁶ It noted that the Report pays particular attention to evaluating a carrier’s SIU referrals and use of medical cost containment in PIP and BI claims. CAR stated that its examiners evaluate files to determine those which need special handling and calculate the number that should have received such handling but did not. Warnings and penalties, it asserted, are issued when appropriate for failure to meet qualitative standards.

Addressing the penalties in the proposed performance standards, CAR commented that, even though the 2004 Annual Report found carriers to be in compliance with the performance standards, in 2003 it determined that fifteen of those carriers did not meet the standards, and issued warnings and one financial penalty. CAR argued that the fact that the fifteen carriers improved their performance to a compliance level demonstrates that the first-year warning in the existing penalty structure is effective. It pointed out that in the 2004 review of commercial carriers, five were warned and two were fined. Because the proposed standards add requirements, increase the benchmarks for compliance, and change

⁶ No participant in the hearing defined task measures. However, CAR’s April 2005 report on compliance reviewed whether carriers had performed such tasks as timely assignment of appraisers, transmittal of appraisals, and direct claim payments, compliance with reinspection requirements, adequacy of documentation in physical damage claims, timely contact with injured PIP claimants, and compliance with the insurance claim intercept program.

the review procedures to include more files, CAR recommended that no change be made to the penalty provisions.

CAR asserted, finally, that Ms. Blank's recommendation that it engage an independent consultant to validate the development of new standards is redundant, because its proposed standards adopt recommendations made by Tillinghast in 2004. Further, it stated, it has modified the benchmarks on the standards and the review process to follow NAIC Guidelines.

2. The SRB

Ms. Blank's post-hearing written testimony and the 21 exhibits attached thereto focused on the three areas addressed in her statement at the July 15 hearing. Ms. Blank noted that proposed changes to the standards for bodily injury claims add standards relating to the initial investigation and litigation of bodily injury claims, and standards relating to tasks associated with claim handling and forms management, matching them, in effect, to standards now in place for PIP claims. Ms. Blank characterized these changes as primarily task oriented and consistent with current industry practice for bodily injury claims, commenting that adding them to the CAR standards in effect reflects practices that are generally already in place as internal standards at any company that handles bodily injury claims. She commented that these standards support audit inquiries that produce yes/no answers, and may produce a consistent scorecard for all carriers, but do not provide an assessment of overall claim handling quality or effectiveness. She asserted that these new standards will not help CAR auditors to identify claim overpayments or possible payment of fraudulent claims, measures that are required under §113H.

Ms. Blank criticized CAR's proposed loss management standard, noting that its language provides no objective, well defined standard against which performance can realistically be assessed. The language added to the standard addressing settlement negotiations or claim denial, she asserted, also does not provide a measurable basis for determining whether a company has a reasonable settlement evaluation plan. As noted above, Ms. Blank defined "leakage" as a best practice that addresses the amount by which individual claim payments differ from established targets or ranges, further observing that identifying leakage requires considerable measurement and training for auditors. The CAR

proposed standards, she asserted, do not assist a CAR auditor to assess claims outcomes or overpayments, and do not address claim leakage.

As she did at the July 15 hearing, Ms. Blank emphasized that CAR's proposed standards provide no information on methods for identifying or measuring performance relating to any differential between the handling of claims on ceded and on voluntary policies. Her written testimony presented data that support her statements on the different loss outcomes under ceded and voluntary policies, and the increases and decreases in the annual injury losses per vehicle over a seven-year period, from 1997 through 2003. Ms. Blank reported revised values for the comparative data underlying her July 15 testimony. She stated that after she testified she performed new calculations analyzing data showing ultimate claim and loss estimates reported through 24, rather than 15 months. Based on these later calculations, the annual expected rate of increase in the average loss per vehicle for ceded policies was revised downward to seven percent. She testified that the later data still demonstrate that there are more claims per accident associated with ceded policies and that more injuries qualify as bodily injury claims on ceded than on voluntary policies. Ms. Blank stated that a separate analysis of the Massachusetts no-fault system observed that claim build-up in order to exceed the \$2,000 threshold for bodily injury liability claims was more prevalent in the seven cities. In addition to reiterating her earlier testimony on cession rates, losses, treatment patterns, and attorney representation on claims for vehicles insured in the seven cities, Ms. Blank stated that 77 percent of all Massachusetts injury claims that are settled for under \$20,000 are for neck or back strain/sprain and that minor injuries, *i.e.*, those in which there is no visible sign of injury, account for another 12 percent of injury claims.

Ms. Blank concluded, based on these data, that the sustained growth of injury claims on policies ceded to CAR indicates that claim management for the pool is not the same as claim management on voluntary policies. The data incorporated into her written testimony show that over 50 percent of injury losses in the seven cities are paid on ceded policies issued to roughly 20 percent of the vehicles insured in those cities. Ms. Blank asserted that the drop in claims for personal injury in the city of Lawrence, after initiation of a fraud task force, supports the conclusion that claim handling differs on ceded policies. She observed that performance standards that emphasize task measures, particularly for

physical damage and PIP claims, do not identify claims practices that will prevent overpayment of claims, and that attention to bodily injury settlements is critical to ensuring that claims are not systematically overpaid.

Ms. Blank concluded that the CAR audit process cannot meaningfully measure the difference between claim handling practices and outcomes on ceded and voluntary policies because the performance standards include no objective, quantifiable standards on this aspect of claim handling. She stated that from 1999 to 2004 the claim samples that CAR audited have increasingly focused on claims from ceded policies, a situation that makes it more difficult to develop an objective frame of reference for assessing differences in performance on ceded and voluntary claims. Further, Ms. Blank commented, failure to review a meaningful number of files on claims from voluntary policies effectively means that there is no basis on which to evaluate company performance in that sector.

The third principal focus of Ms. Blank's written testimony is the performance standard provisions for non-compliance. She stated that the performance standards effectively monitor the claim handling process, but are weak at distinguishing companies based on the quality of claims performance, especially with respect to claims on ceded policies. Section 113H, Ms. Blank noted, provides for two types of penalties as a result of non-compliance with the performance standards: 1) an adjustment to the fixed-and-established rate; and 2) an adjustment to a company's participation in the sharing of premium, losses and expenses of ceded vehicles. An adjustment to the rates, she contended, does not necessarily produce a clear understanding of the operational changes that are needed, and therefore reduces the likelihood of meaningful change. Further, unless an audit process is associated with the industry-wide adjustment, companies will assume that all their operations are similar to those of their competitors, and have no basis on which to modify their performance. Ms. Blank observed that companies may perceive an industry-wide rate adjustment as an arbitrary reduction of premiums that will affect their decisions about doing business in Massachusetts. The *Decision on 2005 Private Passenger Rates*, she noted, reduced total BI and PIP losses, based not on the performance standards but on a filing by the Automobile Insurers Bureau ("AIB") that, like the CAR standards, offered little in the form of performance standards or benchmarks.

Ms. Blank's written testimony, consistent with her oral testimony, pointed out that CAR's proposed standards do not change the current penalties for non-compliance and continue to define two levels of non-compliance: minor and major. Minor non-compliance is defined as that which does not affect the quality of claim handling and does not result in overpayments. Major non-compliance will be found if a company fails to meet the performance standards with a resulting effect on claim handling and possible overpayments. A finding of minor non-compliance results in neither a warning nor a penalty. A company is notified of major non-compliance and warned that, in order to avoid penalty, subsequent review must reflect compliance.

Delayed imposition of financial penalties for non-compliance, Ms. Blank stated, does not respond to the financial effect that non-compliance has already had on the industry and on insurance rates. In addition, because fines vary by company market share, as the company increases by size, they represent a decreasing percentage of a company's otherwise applicable deficit share. A table at page 15 of her written testimony demonstrates that the penalty for non-compliance with the performance standards is greater for small companies than for large companies. Ms. Blank also noted that a penalty for an individual company on a per vehicle basis is less significant than a penalty imposed through the rates.

Ms. Blank pointed out that, in a competitive insurance market, companies would rely on management and efficient practices to ensure that they could compete with other companies. Absent such a market, she asserted, the CAR performance audit process could be utilized, particularly in the area of fines, to improve management of claim handling. Ms. Blank noted that the CAR 2004 Annual Report reflects the first attempt to audit exclusive representative producers ("ERPs") with high loss ratio books of business, almost three quarters of whom are located in the seven cities that, as discussed above, have both a higher than average cession rate and higher than average claim costs. Ms. Blank pointed to testimony from CAR that ERP business produces over three-quarters of the vehicles ceded to CAR and that, in 2003, 60 percent of the CAR deficit resulted from vehicles ceded by ERPs whose books of business have three year loss ratios above 125 percent. She attached to her written testimony two exhibits from the Tillinghast report detailing the financial effect of ERPs on each company writing private passenger automobile business; those

sections show the combined effects of CAR's ERP assignment process and company management of its assigned ERPs. Ms. Blank noted that ERPs present varying challenges to companies to maintain reasonable levels of deficit shares, but that companies have a management responsibility to control costs on all policies by maintaining high standards and providing claim and agency management support, without regard to the producer's status. She concluded that there are significant differences among company claim and agency management practices that measurably impact the financial deficit of the residual market, and that the CAR proposed performance standards, even if improved from the existing standards, are not sufficient to meet the statutory requirements.

Ms. Blank recommended that the Commissioner modify CAR's proposed standards so as, first, to order CAR and its member companies to develop objective and quantifiable means for evaluating all claims, including those for bodily injury, relative to measurable standards of performance. Those measurements should include 'leakage' as that term is used in industry best practices, both with relation to agency management and claim handling. Second, the Commissioner should instruct CAR to develop equitable, meaningful and objectively derived adjustments to company deficit shares for failure to comply with the standards. Ms. Blank recommended that CAR be directed to retain independent outside consultants to facilitate and validate the development of these standards and adjustments.

Discussion and Analysis

The enabling legislation for the residual market, G.L. c. 175, §113H (C)(iv), requires that the governing committee of the plan prepare performance standards for the handling and payment of claims by servicing carriers, and specifies that those standards shall be "designed to ensure the speedy settlement of valid claims at the lowest reasonable cost and the denial of fraudulent or otherwise invalid claims." The plan must also collect and maintain data on compliance with the performance standards and report such information annually to the Commissioner. It further provides that the information on compliance may be the basis for adjustments to premiums. Subsection (E), ¶12, expands the requirements for performance standards, stating that they shall include, but not be limited to, programs to control costs and expenses as described in §113B, for risks insured

in the plan. The plan is to develop pre- and post-payment screening systems to “identify claims overpayments, possible fraudulent claims, and inefficient claim handling practices.”

The statute requires that all insurers issuing policies insured by the plan comply with the performance standards, and that all members of the plan be periodically audited to determine compliance with them. The audits are to include policies not insured through the plan in order to determine whether differences in claim handling exist between policies insured voluntarily and those insured through the plan. Rules relating to the submission of data to the plan are to include penalties for items such as late submissions or faulty data, and adjustments in the allocation of premiums, losses and expenses for companies that do not meet the performance standards or comply with audit requirements. The adjustments are to reflect excessive claim payments which result from noncompliance.

The statutory requirements are reflected in Rule 10 of the CAR Rules of Operation, which states that the Governing Committee, or CAR’s vice-president for claims, shall establish and supervise procedures for the review of claim practices by servicing carriers. As now in effect, Rule 10 states that claim practices for ceded business shall correspond with those followed for voluntary business.⁷ It requires that servicing carriers, among other things, adopt and implement reasonable standards for the prompt investigation of claims and conduct internal claim quality audits of a reasonably representative number of claim files to verify compliance with established procedures and standards. Carriers are to prepare internal reports summarizing their internal quality audits of their claims departments. However, under the current rule, carriers may, in those reports, consolidate comments on their handling of claims on both ceded and voluntary policies, or limit the content to ceded claims only. Further, each carrier is given discretion to develop its own report format, or to utilize a model requested, for an individual company, by CAR. Rule 10 also requires that the claim handling practices of servicing carriers avoid the acts that are identified in G.L. c. 176D, §3 (9) and (10) as unfair claim settlement practices.

The statute anticipates that the residual market plan will utilize performance standards to attain three principal industry-wide goals: 1) efficient claim handling that results in settlement of valid claims at reasonable costs, denial of fraudulent or otherwise

⁷ The Commissioner approved changes to Rule 10 in a decision, issued on December 31, 2004, that was later vacated by the Superior Court. *Commerce Insurance Company v. Commissioner of Insurance*, Suffolk Superior Court Docket No. SUCV2005-00032.

invalid claims, and control of insurer costs and expenses; 2) identification of any differences between the voluntary and the ceded market in claim handling practices; and 3) compliance with the standards. Failure to comply with the standards may generate financial consequences, in the forms of adjustments to premiums or to the allocation of premiums, losses and expenses, and the imposition of penalties. CAR and the SRB disagree on the effectiveness of the proposed standards at meeting those goals.

The current and proposed performance standards, in large measure, require servicing carriers to establish programs and procedures for claim handling, to have plans in place for such purposes as addressing particular aspects of claim handling or ensuring compliance with Massachusetts regulations, and to maintain certain documentation. The section on physical damage and property damage liability claims, for example, requires carriers to have Direct Payment Plans, to follow regulatory guidelines to determine the value of total losses, to provide guidelines for appraisers, and to report repair shops that engage in prohibited practices to the Division of Standards. For PIP claims, carriers must have plans that include consideration for arranging for independent medical examinations and other procedures intended to contain medical claim costs. Some standards are phrased in terms of what carriers “should” do, or what the goals of claim handling procedures, such as initial screening “should” be. The standards set time frames for performing certain tasks, such as assignment of a physical or property damage liability claim to an appraiser or contacting injured persons making claims under the bodily injury or PIP coverage, but not for completing initial screening or investigation of claims.

The Tillinghast Report on CAR commented that the current Standards emphasize handling of first-party physical damage and PIP claims, and that they should place more emphasis on the handling of third-party bodily injury claims. It further concluded that the Standards do not sufficiently monitor the quality of claim handling or provide for an objective assessment of claim handling relative to well defined benchmarks. CAR’s proposed Standards, in response to the Tillinghast Report, now include a section on handling bodily injury claims that, where appropriate, parallels the procedures for handling PIP claims. This addition recognizes that bodily injury claims contribute significantly to loss costs and that it is appropriate to give them the same level of attention as PIP and

property or physical damage claims. We commend CAR for incorporating bodily injury claims into the proposed Standards.

The proposed Standards do not, however, address in any meaningful way Tillinghast's concerns about monitoring the quality of claim handling and measuring performance against clear benchmarks. That audits determine that carriers have plans and procedures in place, comply with regulatory requirements, document actions taken on claims, and comply with time limits does not provide a sound basis for concluding that their claim handling operations satisfy the statutory requirements of settling valid claims at reasonable costs, avoiding payment on fraudulent or invalid claims, and controlling expenses. Successful outcomes on bodily injury or PIP claims should be measured based on the validity of the claims, and the appropriate amount of associated losses. A meaningful standard will therefore examine factors that are relevant to assessing those outcomes. Evaluating compliance with reference solely to timely performance of particular tasks exalts claim handling form over substance.

Ensuring that industry-wide claim handling standards meet the statutory goals and developing a comprehensive audit process to ensure compliance with those standards is a difficult task. CAR's statements, the requirements of Rule 10, and the paucity of specific requirements in the CAR Performance Standards acknowledge that companies have developed and utilize their own internal claim handling procedures. However, particularly to the extent that such procedures incorporate well-disseminated industry-wide "best practices," it is reasonable to expect their material aspects to be virtually identical. The more significant tasks for CAR are measuring the degree to which application of those procedures are producing desirable outcomes for individual companies on ceded claims and identifying material differences among company-specific results.

Under Rule 10, companies are required to evaluate their internal compliance with the CAR Standards and procedures through internal claim quality audits of a "reasonably representative" number of claim files on ceded business. They are then to prepare reports summarizing their efforts and conclusions of the internal audits. Because neither the Standards nor Rule 10 prescribe a format for those reports, it cannot be ascertained whether they provide a reasonable basis for comparing company claim handling results. Ms. Blank's written testimony enlarges on the concept of "leakage" as a best practice that,

by identifying the amount by which individual claim payments differ from established targets or ranges, allows auditors to assess performance relative to established standards. CAR asserts that no single standard exists for evaluating leakage; it further states that its audit procedures do address the issue, pointing out that its auditors address overpayments resulting from missed deductibles or payment of claims for bodily injury that do not meet the threshold. Claim overpayments, however, do not result solely from relatively easily identified failures to pay in accordance with the specific terms of the policy; they occur whenever payments are made, for example, for excessive medical bills, questionable injuries, or unreasonable repair costs. To comply with the statute, effective claim handling must address components where standards may be less clearly defined and departures from them less obvious.

To that end, CAR is directed to incorporate into its Performance Standards and audit procedures provisions that will ensure that carriers have a clear understanding of what is expected in terms of the quality of their claim handling operations, as they relate to the prompt payment of valid claims, avoidance of fraudulent or otherwise invalid claims, and control of expenses. The Standards and audit procedures should also establish a reasonable basis on which to compare the performance of individual carriers. For example, CAR should consider establishing standard methodologies and reporting formats for company internal audits.

The statute requires that the performance standards identify any differences in claim handling practices between the voluntary and the ceded market. CAR has instructed its member companies, through its Rules and the Performance Standards, that claim handling procedures are not to be altered depending on whether the policy is ceded or written voluntarily. Rule 10 states that claim practices for ceded business shall correspond with those followed for voluntary business. Both the current and proposed Standards state that “[t]here will be no differences in claim handling between policies insured voluntarily and those ceded to CAR.” In addition, they prohibit inclusion in the claim file handling of any evidence as to whether the policy is voluntary or ceded, except for required statistical coding.

The SRB asserts the Standards include no method for identifying and measuring the extent of any differential in claim handling practices between the ceded and voluntary

markets. CAR opposes inclusion of any standards relating to this issue, arguing that the statute prohibits employing different claim practices on ceded and voluntary policies, the Standards instruct carriers not to differentiate claim handling on that basis, and that their audits have not uncovered any such differential. As evidence that its audits address failure to comply with the Standards, CAR stated that its examiners require an explanation from any carrier whose claim file identifies a claim as made on a ceded policy. In further support of its position that the Standards on ceded and voluntary claim differential need not be changed, CAR noted that it generally conducts its examinations at company claims offices, that the same staff handle both ceded and voluntary policies, and that in many companies the adjusters do not know which policies are ceded.

CAR's approach states that, pursuant to G. L. c. 175, §113H, companies' claim handling procedures may not differentiate between ceded and voluntary policies and that its audits have not shown any such differential. CAR's reliance on the statute is misplaced. Section 113H includes no explicit statement of the appropriate relationship between performance standards for claim handling and fraud control in the residual market compared to those in place for the voluntary market. It requires that audits of company compliance with the standards include policies that are not insured by the residual market plan "in order to determine whether there is a difference in claim handling between policies insured voluntarily and those insured or reinsured by the plan." Objecting to inclusion in a claim file of information that identifies a policy as ceded effectively prevents any meaningful analysis of whether a differential exists.

It is reasonable to expect that a starting point for all claim handling, from both the residual and voluntary markets, includes time standards and demonstrably successful claim management techniques. CAR notes that its file reviews indicate that companies do apply the same techniques to all claims. However, whether the performance standards, as applied to the residual market, meet the statutory requirements cannot be measured exclusively by determining compliance with a standard set of claim handling mechanics. Audits that focus on meeting time standards, or determining that companies have programs in place, do not produce an analysis of qualitative differences in claim handling results. Consistency in following mechanical procedures does not measure skill at determining the appropriate steps necessary to achieve a desirable result.

It is equally reasonable to expect claim handling to result in payment of legitimate claims and avoidance of fraudulent claim payments, whether the claim arises from a policy retained voluntarily or ceded to the residual market. To the extent that CAR's position that there can be no difference in claim handling is intended to achieve that goal, it has articulated an appropriate standard. However, articulating a standard that simply prohibits differences in claim handling has not been shown to be effective in reaching that result. Furthermore, CAR's position fails to consider whether different approaches to claim handling may be appropriate in some circumstances.

The data reported by the SRB demonstrate significant differences in the average loss per vehicle on ceded and voluntary policies, in the number of claims per accident, and the number of injuries that qualify as bodily injury claims. Furthermore, the data show that these differences persist over time. While some difference in claim frequency is expected, because drivers ceded to the pool are likely to have worse driving records, the severity per claimant for bodily injury claims is relatively similar regardless of whether it is on a ceded or voluntary policy. Ms. Blank concluded that the difference in losses generated by policies ceded to CAR indicates that claim management for the residual market is not the same as that for the voluntary market. She notes, as well, that a fraud task force in the City of Lawrence has resulted in a 68 percent reduction in initial personal injury claims for the first nine months of 2004, compared to 2003.

CAR's task, in implementing performance standards and evaluating compliance with them, is to ensure that claims submitted on ceded policies are handled so as to achieve the statutory goals of settling claims at the lowest reasonable cost and denying fraudulent or otherwise invalid claims. Data on the growth of losses in the residual market do not support CAR's position that carriers handle claims on ceded policy as effectively as those on voluntary claims.

With respect to fraud, the Standards provide that if, in the course of screening and initial investigation, "serious" discrepancies or other indications of potential fraud develop, the claim should be referred for special investigation. For bodily injury and PIP claims, the standards list "an unusual number of injured passengers" as a fraud indicator. Despite the existence of that guideline, the data indicate that neither the carriers nor CAR have meaningfully focused on this indicator as expressed by the frequency of claims per vehicle

or the number of claims that exceed the tort threshold. The dramatic success of the Lawrence task force at reducing the number of initial claims is not a substitute for the ongoing use of claim handling procedures to identify those which are fraudulent or otherwise invalid. It is essential to provide effective training in fraud recognition for all those who participate in claim handling, whether they are producers, company staff, or third parties with which the company contracts to provide such services. Any such training, further, should include a process for evaluating its results.

The SRB also pointed out that in excess of three-quarters of the business ceded to CAR is produced by ERPs, and that 60 percent of the CAR deficit in 2003 represented losses on ceded policies produced by ERPs whose books of business had three-year loss ratios above 125 percent. As Ms. Blank pointed out, CAR's Claims Department in 2004 did a detailed review of claims from ERPs with high loss ratios ("HLR ERPs"). Its 2004 Compliance Report, at p. 11, concluded that there were several areas for improvement in the handling of claims from HLR ERPs, and that CAR's claims advisory committee had, based on the Claims Department review, developed an improvement plan for HLR ERPs.⁸ Recognition that a sector of the market produces higher than average losses and that more extensive oversight may help reduce such losses is a first step to implementing appropriate claim handling procedures. However, a report that "the majority of companies are making efforts to control claims and premium avoidance" tacitly acknowledges that not all companies have undertaken to do so. Further, CAR sidesteps any analysis of the success of company efforts.

CAR's conclusion that claim handling on policies produced by HLR ERPs could be improved is not entirely consistent with its concern that requiring carriers to follow guidelines for ceded claims, in addition to programs the carriers now have in place, would lead to a difference in their handling of such claims. Its position begs the question of whether the problem to be addressed is provisions in the current programs or how well they are applied. Assuming, *arguendo*, that carriers have in place appropriate industry-wide standard procedures, CAR must determine whether such procedures are applied equally vigorously to ceded and voluntary policies. If claims on ceded policies cannot be

⁸ The Commissioner, in her November 23, 2004 *Order on Proposed Changes to the CAR Rules of Operation*, recommended changes to CAR Rules 13 and 14 that would require carriers to set up agency management plans for all ERPs.

successfully resolved using standard procedures, CAR should determine what different procedures are needed in order to ensure that, on similar claims, claim handling produces similar results for both ceded and voluntary policies. Further, its audits should continue to examine closely claim handling on policies produced by ERPs, particularly HLR ERPs, to determine whether all carriers are taking appropriate steps to control losses on ceded policies.

The third area addressed by the SRB is compliance measurements and penalties for failure to meet those measurements. In response to the Commissioner's concerns, CAR's proposed Standards adopt new compliance thresholds that are consistent with those in the NAIC Market Conduct Examiners Handbook. Those thresholds are higher than those now in place and their adoption is a positive step. As discussed above, however, compliance with standards that do not specifically consider results is insufficient to measure success at meeting the goals of the CAR Performance Standards. In light of the additions to the performance standards, and the higher compliance thresholds, CAR urges the Commissioner to retain its current penalty structure which, in essence, allows carriers a year to correct claim handling problems that are identified by a CAR audit. A penalty is imposed only if, at the next audit, the problem persists. CAR also asserts that its system is effective because in most cases carriers do meet the compliance benchmark in the following year.

CAR's approach, however, provides little incentive for a carrier to monitor vigorously its claim handling procedures in order to avoid financial penalties. A carrier may relax its claim handling practices secure in the knowledge that, even if a CAR audit reveals failure to comply with the Standards, no financial penalty will be imposed unless it is unable to correct the problem within a year. The lack of any immediate sanctions for failure to meet the performance standards, combined with audits that do not emphasize claim results, and the knowledge that losses on ceded policies will be shared, means that carriers will suffer few direct consequences if they minimize claim handling on ceded policies. At the same time, carrier failure to ensure that claim handling procedures resolve valid claims at reasonable costs, avoid paying invalid or fraudulent claims, and contain costs effectively increases the deficit share that all companies must share. Ms. Blank also

pointed out that, under the current system, penalties for non-compliance with the standards are greater for smaller than for larger companies.

The statute permits two types of penalties for failure to have adequate claims handling procedures in place: industry-wide adjustments to premium and adjustments in the allocation of premiums, losses and expenses for companies that do not meet CAR's performance standards. The Commissioner, as part of hearings to fix and establish rates, considers evidence relating to the industry's overall performance on the issues of cost containment and fraudulent claims. CAR, as a result of its responsibility for managing the residual market is in a position to evaluate and compare performances by individual carriers, and to develop a fair penalty structure.

To encourage a high level of compliance with performance standards, an effective system should consider both penalties for poor performance and rewards for exceptional performance. Rewards and penalties need not be structured in the same fashion; the Commissioner's November 23 *Order on Proposed Changes to the CAR Rules of Operation* addressed issues relating to developing an incentive program that would reward the industry for collective achievements in reducing losses on policies produced by HLR ERPs. Her modifications to CAR's proposed Rule 17 recognized that effective claim management requires collaboration and cooperation among carriers and that, in order to avoid gaming the system, savings are appropriately distributed to all carriers.

Conclusions

CAR asks the Commissioner to approve its proposed Performance Standards, without modifications, and to delay their implementation for sixty days. We are persuaded that CAR's proposed additions to Sections I, II, III and V of its Performance Standards, that are intended to reflect NAIC requirements, are appropriate and should be approved. CAR's proposed changes do not, however, address the important question of the success of those standards, as applied, at achieving the statutory goals. CAR's arguments for retention of the current performance Standard IV on claim differentials for ceded and voluntary policies are not persuasive, and that section is disapproved. CAR is to develop a revised Standard IV that, as required by statute, will permit a meaningful analysis of the differences between claim handling on voluntary and ceded policies.

Implementation of the proposed additions to Sections I, II, III and V of its Performance Standards is hereby delayed for 60 days. Within that period, CAR is directed to resubmit the performance standards. As resubmitted, the standards should include revisions to Section IV, and additions to CAR's audit procedures that will allow it, consistent with §113H, to evaluate and compare individual company performance on the handling of ceded and voluntary claims, to assess and compare the quality of claim handling among companies, and to evaluate the effectiveness of the standards at meeting the statutory goals. The sampling technique that CAR adopts should ensure adequate review of claims on both ceded and voluntary policies.

Similarly, CAR's proposed benchmarks for compliance with claim handling standards are based on the NAIC requirements and are hereby approved. However, for the reasons set out above, CAR's proposed penalties are not approved. Within 60 days, CAR is to submit a revised structure that imposes immediate financial penalties on companies that fail to meet the performance standards including, but not limited to, a formula for adjusting the allocated deficit share of those companies. It is also to take appropriate steps to develop a system to institute rewards for successful industry-wide efforts to reduce losses in the residual market. We reach no conclusion on the engagement of outside consultants to assist in these matters, but hope that CAR will not categorically rule out such an option.

September 12, 2005

/s/ _____
Jean F. Farrington
Presiding Officer

/s/ _____
Julianne M. Bowler
Commissioner of Insurance