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**Commonwealth Automobile Reinsurers'**  
**Proposed Amendments to Rules of Operation 11 and 12, and**  
**Rules 29 and 31 of the Massachusetts Automobile Insurance Plan**  
**Docket No. C2007-04**

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**Order on Proposed Amendments**

**Introduction**

On November 14, 2007, the Governing Committee of Commonwealth Automobile Reinsurers ("CAR") voted to amend Rules 11 and 12 of its Rules of Operation and Rules 22, 29 and 31 of the Massachusetts Automobile Insurance Plan ("MAIP") Rules of Operation (the "Amendments"). Pursuant to Article X of the CAR Plan of Operation, CAR submitted the Amendments to the Commissioner for her approval. By letter dated December 13, 2007 the Commissioner informed CAR that she had approved the amendment to Rule 22 but disapproved the amendments to Rules 11, 12, 29 and 31. On the same date, she issued a hearing notice scheduling a hearing for December 27, 2007 to accept testimony about the proposed amendments.

Natalie Hubley, CAR's vice-president of Financial Services, was the principal speaker at the December 27 hearing. The only other participants were Joseph J. Maher, Jr., CAR's general counsel, and Pamela Wallace, a CAR staff member. Two insurance companies and the Exclusive Representative Producers of Massachusetts, Inc. ("ERPM") submitted written statements, all in support of the proposed amendments.

CAR Rules 11 and 12 address the determination of Assessments and Participation for each member company and the establishment of Credit Provisions available to

member companies which voluntarily write business in credit-eligible territories and classifications that otherwise would be disproportionately represented in the residual market. CAR customarily reviews these rules annually and amends them to establish participation criteria and credit values for the following policy year.<sup>1</sup> The proposed amendments update Rules 11 and 12 to cover the policy year beginning April 1, 2008.

MAIP Rule 29 relates to the process for assigning applicants for insurance through the MAIP to individual member companies. Rule 31 addresses the requirements for certification of assigned risk producers (“ARPs”). CAR’s proposed amendments to those rules revise the Rules that the Commissioner of Insurance (“Commissioner”) approved in a Decision dated July 16, 2007 (the “*July 16 Decision*”).

### **Discussion, Analysis and Conclusions**

#### **A. Rule 11**

Rule 11.B prescribes the method for calculating the pre-credit utilization ratio for each member company, including a K factor.<sup>2</sup> The utilization ratio serves as the basis for allocating the residual market deficit to Member companies, and is developed from each member company’s voluntary and ceded exposures.<sup>3</sup> Certain exposures are excluded from the calculation of the utilization ratio. The proposed amendment to Rule 11. B extends the exclusion criteria in place for policy years 2006 and 2007 through 2008 and retains the current K factor. As part of the utilization formula, Rule 11.B also establishes minimum allowable exposures for each company, and includes a methodology for adjusting the company’s voluntary-ceded exposures if the minimum allowable exposures are greater than the total of the voluntary and voluntary-ceded exposures.

CAR’s proposed amendment adds two specific categories of risks to be included in the calculation of a company’s voluntary and voluntary-ceded exposures for policy year 2008. The amendment refers to two new identification codes, 7 and 8, which separately classify risks written through a group marketing plan and risks eligible for the MAIP that

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<sup>1</sup> Prior to these proposed amendments, Rule 11 applied only through policy year 2007, and Rule 12 provided credits for policies with effective dates between January 1, 2006 and March 31, 2007. Rule 12 provides for annual determination of the specific credit factors.

<sup>2</sup> Determining a company’s share of the CAR deficit begins with a determination of its total market share. The K factor adjusts a company’s exposure-based market share to reflect the extent to which the company’s cession rate is higher or lower than the industry average.

<sup>3</sup> The residual market deficit consists of the premiums, losses and expense allowances associated with business ceded to CAR.

a company chooses to retain as voluntary business. CAR's testimony indicated that the changes are intended to ensure that companies properly report voluntary exposure volumes after transition to the MAIP and that voluntary exposure volumes are made on a similar basis for the current and prior year.<sup>4</sup>

*Analysis and Conclusion*

CAR stated that its proposed amendment to Rule 11 in large measure extends factors that have been constant for years. Its proposed change to the calculation of minimum allowable exposures is made as a result of the transition to the MAIP, and is intended to produce a consistent comparison between a company's writings from year to year. Ms. Hubley stated that the proposed amendment did not change the group marketing provision in Rule 11 and that, for comparative purposes, all retained business would be included in the company data. She also confirmed that only business that is not eligible for the MAIP is counted for the purpose of sharing the CAR deficit. The codes separately identify business that is CAR eligible and business that is MAIP eligible.

We are concerned that CAR's proposed amendment to Rule 11.B.1 will alter the deficit share of all companies and may distort the minimum allowable adjustment. The existing statistical codes of 0, 1, 4 and 5 appear to be sufficient for allocating the residual market losses for risks that are not MAIP eligible in the first year of transition to the MAIP.<sup>5</sup> In order to maintain the integrity of the minimum allowable exposure provision in Rule 11.B.1.b, it is appropriate to recognize company retention of direct-written MAIP-eligible business in the transition year. CAR's reference to exposures with CAR ID Code 8 appears adequate to capture such business. Proposed ID Code 7 appears to be a subset of ID Code 8. We are concerned that CAR's proposal, as it relates to exposures assigned ID Code 7, could, if implemented, potentially lead to distorted measures of the minimum allowable provision. We disapprove the language in the penultimate paragraph of Rule 11.B.b, that references CAR ID Code 7. CAR is to strike the following language from

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<sup>4</sup> The minimum allowable provision provides for an adjustment of an insurer's deficit share if the exposures produced by voluntary agents (both ceded and retained) decline by more than 20 percent per year. The minimum allowable adjustment, if triggered, increases the count of an insurer's ceded exposures for the purpose of calculating its deficit share. For the purpose of calculating an insurer's overall deficit share, however, "voluntary" market share means exposures retained by the insurer, regardless of who produced them.

<sup>5</sup> CAR ID Codes are established as part of the statistical plan for reporting insurance business that the Commissioner approves pursuant to G.L. c. 175A, §15.

that paragraph: “voluntary business written under a group marketing plan pursuant to G.L. c. 175, §193R that would otherwise have been rejected in the voluntary market (CAR ID Code 7).” With that revision, we approve CAR’s proposal to amend Rule 11.

#### B. Rule 12

Rule 12 determines the credits that CAR members receive each year for writing private passenger automobile business voluntarily in territories and classifications that otherwise would be represented disproportionately in the residual market. The rule requires CAR to review the credits annually and to make any necessary adjustments. CAR’s proposed amendment determines the participation credits that will be given to companies for retaining voluntarily private passenger automobile policies with effective dates from April 1, 2008 through March 31, 2009 that are written in credit-eligible territories and classifications. The value of a credit is based on a current projection of the residual market deficit and the most recent subsidy data.<sup>6</sup> Ms. Hubley stated that CAR used the same process to calculate the Rule 12 credits this year that it has used previously. That approach allows companies to recognize actual underwriting losses and to receive credit for each rate that is subsidized. Utilization of that process, incorporating the current deficit projection and rate subsidies, generated a reduced credit provision for 2008. We agree with this approach and approve CAR’s proposed amendment to Rule 12.

#### C. Rule 29

CAR’s proposed amendment focuses on changes to the methodology for calculating each company’s MAIP quota share from that approved in the *July 16 Decision*.<sup>7</sup> CAR proposes to abandon the method for determining a company’s voluntary private passenger market share based on direct written exposures and to add an “average premium relativity factor.” It asserts that the changes are intended to address the quality of the assigned risks to ensure a more equitable distribution of the residual market in terms of both quality and quantity. CAR claims that its proposed amendment is consistent with Rule 29 as approved in the *July 16 Decision*, but replaces a quota share for assigned

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<sup>6</sup> Ms. Hubley stated that for the purpose of calculating the credit provision CAR used the subsidies included in the 2007 rates and the 2006 deficit evaluated as of June 2007.

<sup>7</sup> The need for various technical corrections was pointed out in the course of the hearing. For example, the references to the “fixed-and-established” rates for private passenger automobile insurance are no longer relevant. The rule inconsistently refers to CAR and the MAIP as the entity responsible for performing various functions. CAR is aware of this matter, and will make appropriate technical changes.

business based on premium with one based on exposures, and applies an average premium relativity factor to recognize the quality of the assigned risks.

Ms. Hubley presented a two-page document showing the Rule 29 exposures based on CAR's proposed amendments. Column 1 on page 1 of the exhibit shows quota share based on the company's voluntary market share, but replaces the basis for calculating MAIP exposures from assigned risk premiums to assigned risk exposures. Weighting and off-balancing mechanisms are applied to adjust the MAIP exposures. Measuring assignments in terms of exposures, Ms. Hubley contended, is a simpler, more direct assignment method which companies understand. She noted that in other states, residual market share is determined in part by exposures. Conversion of exposures to premium, Ms. Hubley explained, requires companies to develop three separate premium calculations; CAR's response was to use an average premium relativity factor rather than premium. CAR would change the average premium relativity factor each time the rates change.<sup>8</sup> Its proposed amendment developed relativity factors based on actual MAIP rates and current territory and driver class relativities, but did not consider SDIP factors.

CAR's proposed amendment also calculates the value of a credit differently for purposes of Rule 29. Although the process is similar to that used to calculate credits for purposes of Rule 12, it recognizes the difference in the way credits are applied to the quota share. The value of a credit is simply the CAR deficit divided by the total retained exposures. CAR's proposed amendment provides that companies newly writing private passenger automobile insurance in 2008 would receive a share of the CAR deficit in the year that they begin writing, rather than in the following year, which would result in delaying assessment for a year. Ms. Hubley explained that the shift to an assigned risk plan from a residual market pool permits CAR to include newly writing companies in the deficit sharing mechanism on a more timely basis.

CAR's proposed amendment alters the process for calculating the voluntary market share, which is the basis for a company's quota share. The proposed amendment permits a company, under prescribed conditions, to exclude from its voluntary market share retained business written through a group marketing plan that, if not written through

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<sup>8</sup> CAR's proposed relativity factors are shown on page 2 of the exhibit.

such a plan, would have been rejected in the voluntary market.<sup>9</sup> To take advantage of the exclusion, the company must satisfy three conditions: 1) document that it has obtained 100 per cent reinsurance for this retained business from a non-affiliated company; 2) demonstrate that the percentage of its total MAIP-eligible group marketed exposures reported under ID Code 7 does not exceed the percentage of the industrywide MAIP market share; and 3) certify that the retained risks do not meet its underwriting criteria. If the company does not satisfy the second condition, *i.e.*, its MAIP exposures exceed the industry MAIP market share, the excess exposures will be added to the voluntary exposures used in the company's quota share calculation. Ms. Hubley stated that the proposed rule, by allowing companies to exclude from the calculation of their quota share group business that otherwise would have been ceded, will ensure an equitable distribution of the residual market. According to CAR, the reinsurance requirement is intended to ensure the bona fides of the group business that the company asserts it otherwise would have ceded to CAR.

Responding to questions about the relationship between MAIP Rule 26, which does not permit companies to place in the MAIP any policy issued through a group marketing plan, and CAR's proposed amendment to Rule 29, CAR stated that companies must retain group business on their books, but that the rule might reduce the amount of MAIP business that would otherwise have been assigned to the company. It thereby would protect the company from any negative financial impact of the requirement that it retain group business. CAR asserted that the proposed amendment would not result in the assignment of additional business to the residual market.

Ms. Hubley observed, in response to questions about the overall effect of the proposed amendments to Rule 29 on quota share calculations, that the volume of business that could be excluded is limited to the industrywide residual market share, and that the cost of obtaining reinsurance would be an expense for the company. CAR had not addressed yet the operational issues relating to determining the standards for reinsurance and how it would be documented. Ms. Hubley did not believe that CAR intended to permit companies to retrocede liabilities or obtain reinsurance on a retroactive basis. She confirmed that companies are expected to continue to service their group business, even if

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<sup>9</sup> Such retained business would be given the proposed CAR Identification Code 7.

part of it is reinsured. CAR argues that the proposed amendment will avoid penalizing companies for writing groups in which some members do not meet their underwriting standards and thus encourage companies to continue to offer group discounts.

CAR's proposed amendments to Rule 29 make a number of additional changes to the rules in the *July 16 Decision*. Rule 29.G, the so-called household procedure rule, requires assignment of a MAIP applicant to the company that voluntarily insures a vehicle owned by a household member, "unless the applicant specifically requests an individual policy separate from the existing policy." CAR proposes to eliminate the quoted language. Ms. Wallace explained that the system CAR has designed asks the applicant if he or she wants the same company as a current household member and, if the applicant does not, assigns the policy through the quota share process. She stated that the principle that an applicant has a choice as to whether he or she wants a separate policy is still effective.

CAR altered the implementation dates for certain activities, postponing the date at which companies might sell, transfer or purchase credits from April 1, 2008 to April 1, 2009. Similarly, it changed the date for developing a credit mechanism to encourage companies to write clean-in-three risks voluntarily from April 1, 2009 to December 15, 2009. Ms. Hubley explained that both changes were made because the MAIP transition date had changed from April 1, 2007 to April 1, 2008.

#### *Analysis and Conclusions*

We have carefully considered CAR's proposed amendment to Rule 29 and conclude that it should be disapproved. CAR has not persuaded us that its revised approach is either simpler than that in Rule 29 as approved in the *July 16 Decision* or would improve the equitable distribution of the residual market. The provisions relating to the exclusion of some policies voluntarily written through a group marketing plan from the calculation of a company's quota share produce a potential for market manipulation that could undermine control over an assigned risk plan. The proposal to exclude business coded in ID Code 7 could play havoc with a fair distribution of the residual market. Current Rule 29.C.1.a refers to *direct* written exposures as the basis for determining market share. Direct, as an insurance accounting term, means that exposures are to be counted before any decisions are made relating to reinsurance. Under the pre-MAIP loss

pooling system, companies coded voluntary retained business as CAR ID Codes 0 or 1; subsequently they could cede that business to a private reinsurer, without affecting the ceding company's residual market burden.<sup>10</sup> All business is considered direct before it is ceded. Cession to CAR is a statistical way of distinguishing between business in the residual and non-residual market. Conversion to the MAIP does not change that principle. Allowing companies to reduce their quota share market by excluding exposures in ID Code 7 from the calculation of their voluntary market share would be unfair, especially to companies that do not aggressively engage in group marketing.

CAR proposes to link the permissible exclusion of group exposures to the industrywide residual market share. Because that industrywide share is not capped, a company could manipulate the industrywide value by increasing its figurative assignments of group business to the residual market, and benefit from the concomitant ability to reduce its quota share. Removal of a portion of a company's voluntarily written group business from the data used in the formula for calculating its quota share would ultimately affect the entire market. By creating a discontinuity between the data that are used to calculate the size of the industrywide voluntary market, and that used to calculate an individual company's quota share, CAR's proposed rule effectively increases the quota shares for those companies that do not offer group discounts. Further, CAR has not addressed issues relating to the determination of an adequate level of reinsurance, the potential effect on rates of reinsurance expenses, or any other appropriate controls on reinsurance purchases.

CAR proposes to replace premium as the basis for establishing the residual market quota with an average premium relativity. CAR's proposed average premium relativity is calculated in part based on the MAIP's actual filed base rates for all coverages combined. It is, as described by CAR, the ratio of the average base rate for each operator class and territory combination to the average statewide base rate. CAR's proposed approach does not fairly reflect the difference between the quality of the risks assigned to each company because the average base rate does not recognize differences in risk. Premiums, on the other hand, reflect specific risk characteristics such as driving record. Any methodology

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<sup>10</sup> CAR ID Codes 4 and 5 signify cession exclusively to CAR.



utilizing an average premium relativity should be based on premiums, rather than base rates.<sup>11</sup>

CAR also expresses its average premium relativity as a percentage of the statewide average premium. The average base rate relativities for risks insured in the residual market do not balance to a statewide total of one, and are not expected to do so in a transitional market. If an average premium relativity is to reflect the actual risk assigned to a member company relative to the universe of eligible risks, the relativity should be expressed as a percentage of the lowest premium for a risk eligible for the MAIP. Such an approach eliminates any need for an off-balance factor and is responsive to changes in the size of the residual market.

The MAIP actual filed base rates that CAR has used for developing the residual market quota reflect the territorial and class subsidies in the Commissioner's *Decision on 2007 Rates*. To provide an incentive to companies to write policies voluntarily in rate subsidized territories, the base rates used to establish the quota share premium should be restated to exclude the effect of those subsidies. Without such an adjustment, companies will not receive fair credit for writing such risks.

CAR's proposed amendment also departs from the use of voluntary, exposure-based market share as the sole foundation for quota share by restating the voluntary market share to reflect the value of credits already earned. CAR's exhibit shows that determination of a company's place on the rota for the next assignment of a residual market risk is based on a ratio of the company's pre-credit quota share to its post-credit quota share. The company's actual credits define both measures. Other assigned risk plans use a more straightforward approach that determines a company's eligibility to receive the next assignment based on the ratio of the sum of the company's actual assigned risk exposures and the credit-eligible risks that it writes voluntarily, divided by its quota share for all such risks. This more transparent approach should improve company confidence in the fairness of the assignment process.

CAR applies a slightly different methodology to determine the value of a credit in Rule 29 than it does in Rule 12. Ms. Hubley described the value of a credit in Rule 29 as

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<sup>11</sup> CAR should also reconsider its development of motorcycle average premium relativity. Its proposed value, 0.33, relates only to liability coverages and is inconsistent with an average premium relativity that includes all coverages. Motorcycle premiums now vary by operator class and rating territory.

“simply the [CAR] deficit divided by the total retained exposures.” This approach does not reflect that the MAIP does not produce a deficit because it randomly distributes risk to each company. Companies are no longer required to share in a common loss pool whose costs are determined after policies are issued. Underwriting losses associated with risks insured through the MAIP and voluntarily written MAIP-eligible business are the full responsibility of the company writing the business. The cost of the residual market to that company’s voluntary book of business is completely within the control of the company and should not be assumed to be a common value for all companies. For that reason, credits in the MAIP are appropriately valued on the same basis as the valuation of the quota, and both should reflect the removal of rate subsidies from the rates underlying the premiums.

We do not find that CAR’s proposed amendment to Rule 29 provides a more equitable approach to assigning risks in the residual market or improves the clarity of the Rule. We therefore disapprove it. We also do not approve CAR’s proposals to extend the dates in Rule 29.H. CAR has, and has had for some time, adequate notice of the need to develop the credit mechanisms prescribed in the current rule.

Although we disapprove CAR’s proposed Rule 29, the provisions of Rules 26 and 29, as approved in the *July 16 Decision*, do not adequately respond to changes in Rule 21 prescribing eligibility for placement in the MAIP over a two-year period. The current rules may disadvantage insurers which write a significant volume of business through group marketing plans by assigning a disproportionate share of MAIP eligible business to those insurers. To address that possible inequity, we would welcome revisions to Rule 29.F. 2 that would offer credits to insurers for retaining any risk written on a direct basis if the risk satisfied the eligibility criteria described in Rule 21.B.3.

#### D. Rule 31

Rule 31.A sets out the requirements that a licensed producer must satisfy in order to be certified by CAR to place business in the MAIP. Subsection 3 lists conditions that an applicant for certification must “conclusively” show that he or she meets. CAR’s proposed amendment excises subsection 3. f, which requires the applicant to demonstrate that he or she “has not been involved in a material and substantial breach of a contract between an ARC or a LADC and a producer.” It argues that the particular terms of a

contract between a producer and an insurance company, and any disputes about the terms of that contract, have no bearing on the producer's certification to place such business. The ERPM supports CAR's proposed amendment, asserting the importance of maintaining consistency for ARPs in the MAIP.<sup>12</sup>

CAR stated at the hearing that the proposed amendment addressed concerns that under the rule as approved in the *July 16 Decision* it would be required to consider any dispute alleging a breach of contract between a producer and an insurer, even though the contract provision at issue did not directly relate to placing business in the MAIP. CAR commented that, in order to avoid that result, it had explored offering a standard contract to govern the relationships between Assigned Risk Companies ("ARCs") and ARPs. It concluded that it would not be possible to implement such a plan. CAR also considered that it lacked authority to set the terms of such contracts insofar as they addressed particular aspects of a company's program, or to hear disputes about contracts to which CAR is not a party.

CAR expressed concern that the language it proposes to strike might effectively prevent some producers, who had contract disputes with companies relating to details of a particular agreement rather than to material or substantive provisions, from satisfying the eligibility requirements for placing business in the MAIP. In response to the suggestion that concerns about Rule 31 might be addressed by modifying the language for greater precision, rather than eliminating it entirely, CAR noted that it could not imagine a contract breach sufficient to preclude certification that would not be covered by the CAR Plan, Rules and Manual.

#### *Discussion and Analysis*

We disapprove CAR's proposed amendment to Rule 31. It is appropriate that CAR, in evaluating applicants for certification as a MAIP producer, consider any incidents of "material or substantial" breaches of contracts with insurance companies. The rule is not limited to contracts relating to the sale of private passenger automobile insurance. Such incidents may be relevant to determining whether the producer should write or service policies placed in the residual market. The issue is not whether CAR can

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<sup>12</sup> The ERPM also asserts that the MAIP rules as they relate to ARPs should be further amended and suggests proposed changes. Such proposals are appropriately brought to CAR's attention.

resolve contract disputes, but the relationship of any incidents to the producer's qualifications for certification as an ARP. CAR has, for many years, reviewed producer qualifications in connection with ERP appointments and heard disputes between companies and producers about continued ERP status. That experience should prove helpful in evaluating compliance with the MAIP qualifications for ARP certification.

**Conclusion**

CAR's proposed amendment to Rule 11 is approved, except for the language specifically relating to business to be coded in CAR ID Code 7. We approve CAR's proposed amendments to Rule 12. CAR's proposed amendments to Rules 29 and 31 are disapproved. CAR is to submit by January 31, 2008, revisions to the credit provision in Rule 29 that are consistent with this decision.

January 16, 2008

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Jean F. Farrington, Esq.  
Presiding Officer

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Elisabeth Ditomassi, Esq.  
Presiding Officer

Affirmed:

January 16, 2008

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Nonnie S. Burnes  
Commissioner of Insurance