COMMONWEALTH OF MASSACHUSETTS

Office of Consumer Affairs and Business Regulation

DIVISION OF INSURANCE

One South Station • Boston, MA 02110-2208
(617) 521-7794 • FAX (617) 521-7475
TTY/TDD (617) 521-7490
http://www.mass.gov/doi

DEVAL L. PATRICK
GOVERNOR

TIMOTHY P. MURRAY
LIEUTENANT GOVERNOR

DANIEL O'CONNELL
SECRETARY OF HOUSING AND ECONOMIC DEVELOPMENT

DANIEL C. CRANE
DIRECTOR

NONNIE S. BURNES
COMMISSIONER OF INSURANCE

Decision and Order on Massachusetts Property Insurance Underwriting Association Rate Filings

R2007-02

I. Introduction and Procedural History

The Massachusetts Property Insurance Underwriting Association ("MPIUA") submitted three rate filings to the Commissioner of Insurance ("Commissioner") on March 21, 2007 for her approval pursuant to G. L. c. 175C, §5. The MPIUA seeks statewide overall rate changes for three types of coverage, as follows: 1) +13.2 percent for Homeowners Multi-Peril, which includes policy forms issued to owners and renters of residential property and condominiums; 2) +8.0 percent for Dwelling Fire and Extended Coverage; and 3) 0.0 percent for Commercial Fire and Allied Lines. The proposed effective date for each filing was July 1, 2007. The MPIUA also filed for approval of a special endorsement for its Dwelling Policy Program.

The Commissioner issued a hearing notice on March 21, 2007, scheduling a public hearing and a prehearing conference for April 27, 2007. The Attorney General intervened as of right; the State Rating Bureau ("SRB") represented the Division of Insurance ("DOI"). The hearing was conducted pursuant to G.L. c. 174A, c. 175A, c. 175C, c. 30A, and 211 CMR 101.00 *et seq*.

Twelve individuals spoke at the April 27 public comment hearing, at which Commissioner Burnes presided. The MPIUA witnesses filed written direct testimony and

were cross-examined on June 6, 27 and 28, and August 1, 6, 27 and 28. The Attorney General and the SRB submitted advisory filings on October 5.[1] The witnesses for the SRB were cross-examined on October 29 and 30; the Attorney General's witnesses were cross-examined on October 31, November 7 and 9, and January 3 and 29, 2008. The MPIUA waived submission of rebuttal testimony, and the parties submitted briefs on March 10, 2008.

The MPIUA proposes to increase rates for homeowners' coverage in all but six of the territories in which it writes policies. The grounds for these increases are potential losses from hurricanes and the putative cost of reinsurance intended to cover catastrophe losses. Absent these factors, the MPIUA's filing shows that homeowners' rates would decrease in all but one territory. We have reviewed the record carefully in this proceeding in light of the statutory standards applicable to MPIUA rate filings, the filing party's burden of proof, and the principles enunciated in our decision on the MPIUA's 2005 rate filing ("*Decision on the 2005 Rate Filing"*). We have concluded, for the reasons set forth below, that the MPIUA has failed to meet its statutory burden to demonstrate that the rates proposed in its 2007 filing are not excessive, and we therefore disapprove its filings.[2] Because this decision is based on findings relating to the timing of the filings, compliance with the *Decision on the 2005 Filing*, and the interpretation of the statute relating to MPIUA rate filings, it does not address some of the other arguments raised by the State Rating Bureau and the Attorney General that address specific substantive aspects of the filings. Many of those issues are discussed in the Appendix to this Decision.

II. Analysis and Discussion

1. <u>The timing of the 2007 filings</u>.

The MPIUA Board of Directors ("Board") voted at its January 4, 2007 meeting to submit filings with a July 1, 2007 effective date.[3] The rates in the filings submitted on March 21 included a net cost of reinsurance greater than $48 million for the period from July 1, 2007 through June 30, 2008, a value derived from an authorized budget

[1] Their submissions were originally scheduled for September 21.
[2] See G.L. c. 174A, §§2, 5(a)(2); G.L. c. 175A, §§2, 5(a)(4).
[3] The record of the Board's vote identifies no reason for selecting that date. The MPIUA's president, Mr. Golembeski, testified that the rates then in place, which had been approved by the Commissioner in August 2006 and implemented as of October 1, 2006, were inadequate because they were less than the indicated rates in the MPIUA's 2005 Filing. He described the 2007 filing as a step toward rate adequacy.

expenditure of $80 million for a reinsurance program.[4] The stated basis for the $80 million value was the Board's January 4, 2007 vote to budget that amount. The MPIUA had not purchased any reinsurance for 2007-2008 when it submitted its filings to the Commissioner on March 21.

The MPIUA bears the burden of supporting in its filings each aspect of its rate requests and proving, by a preponderance of the evidence, that its rates satisfy the statutory requirements.[5] The *Decision on the 2005 Filing* unequivocally stated that it is unreasonable to include in rates a component for reinsurance that has not been purchased, and that prospective expenses should not be included absent evidence that the MPIUA has, or in fact will, incur that expense during the prospective rate period.[6] The MPIUA's initial obligation, this year, was to demonstrate that $80 million was a reasonable gross expense for reinsurance and that it would in fact spend that amount for that purpose.[7] It cannot rely on the January 4, 2007 vote as evidence of compliance with the principle stated in the *Decision on the 2005 Filing*. A budgeted amount is not the equivalent of a "stated sum" reached after careful consideration of the MPIUA's reinsurance needs and the actual cost of the program.[8]

Mr. Golembeski testified that the $80 million was chosen because the Board wanted to increase its reinsurance *coverage* from the level of the 2006-2007 program, and

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[4] The reinsurance program for the period July 1, 2006-June 30, 2007 was in effect when the MPIUA submitted its March 2007 filing.

[5] The standard is set out in *Medical Malpractice Joint Underwriting Association of Massachusetts v. Commissioner of Insurance*, 395 Mass. 43, 46 (1985).

[6] The *Decision on the 2005 Filing* observed that there was no vote from the Board of Directors approving the purchase of reinsurance for a date certain and for a stated sum.

[7] For ratemaking purposes the net, rather than the gross, cost of reinsurance is included in the rate calculation. The MPIUA argues that its estimate of the net cost of reinsurance should be approved because it is based on a methodology used to calculate the $13 million net cost of reinsurance that it sought to include in the 2005 rates. Although the Decision on the 2005 Rates found that the $13 million net cost fell within a range of reasonableness, the arguments in the proceeding on the 2005 filing focused on whether it was reasonable for rates to include a component that did not represent an actual expense to the MPIUA. The *Decision on the 2005 Filing* did not analyze, comment on, or approve the MPIUA's assessment of its need for reinsurance, the reasons for its decision not to purchase the coverage, or the methodology underlying the MPIUA's proposed value for the net cost of reinsurance. The MPIUA may not rely on the 2005 decision as precedent for its proposed value this year.

[8] Basing the cost of reinsurance for purposes of ratemaking on a predetermined budget value is particularly problematic when, according to testimony from James Wackerman, a witness for the MPIUA, reinsurance pricing is shifting downward.

therefore doubled the *premium* it had paid for that program.[9] After the January 4 Board meeting, the MPIUA engaged Milliman, Inc. to provide an opinion on the reasonableness of the reinsurance purchase, among other things.[10] Milliman, Inc. made a presentation to the Board on May 24, 2007, that included a variety of options for the reinsurance purchase. On June 6, Mr. Golembeski testified that no reinsurance coverage was in place for 2007-2008, and that the final cost had not yet been determined. His testimony underscores the dissonance between the Commissioner's goal of basing rates on reasonable actual expenses and the MPIUA's proposal based on a bald budget number.

We find that it is unreasonable to include in a rate a value for reinsurance that is not based on the actual costs for the reinsurance program that the MPIUA expects to have in place during the rate period. What the MPIUA chose to budget for the reinsurance premium is not relevant to the ultimate issue. The MPIUA filings do not demonstrate that its proposed reinsurance program is based on an analysis that substantiates its reasons for purchasing coverage at various levels and that the premium, in light of prevailing market conditions, is reasonable.[11] A March 2007 filing was premature because the MPIUA reinsurance picture was not sufficiently developed.[12]

The decision to submit the MPIUA's rate filings prematurely in March had a second deleterious effect. Prospective ratemaking is based principally on an analysis of historical data, which is examined from various perspectives and adjusted for the purpose of estimating future rate needs. Actuaries, as a general rule, rely on the most recent data

[9] The Board did not have any formal proposal for a reinsurance program or actual cost estimates before it in January 2007. It approved a budget item and then asked its reinsurance broker, Guy Carpenter, to see what it could purchase for that amount. The contract for the 2007-2008 reinsurance purchase was signed on July 10, 2007, nearly four months after the rate filings were submitted.

[10] Urban Leimkuhler, MAAA, FCAS, an actuarial consultant for Milliman, Inc., testified that the MPIUA engaged Milliman early in 2007, following the January 4 Board meeting. As of March 15, 2007, the date of Mr. Leimkuhler's prefiled testimony, Milliman, Inc. had not determined the minimum or maximum reasonable reinsurance purchase because the acquisition program was dependent on an overall strategy for buying such coverage, which the Board was still reviewing. Mr. Ericksen relied on information from Guy Carpenter and Milliman to calculate the net cost of reinsurance. He had no knowledge of the specifics of the MPIUA's reinsurance program.

[11] Because the reinsurance premium is the basis for calculating the net cost of reinsurance, a significant factor in the MPIUA rates, it is essential that the evidence demonstrate that the reinsurance premium is reasonable.

[12] The sequence of events indicates that the MPIUA could not have made filings that realistically reflected the certain cost of reinsurance until late June of that year.

available as a basis for their recommendations.[13] The most recent historical full year data available to the MPIUA when its filings were prepared were for 2005.[14] The loss data underlying the filing were from that year; the loss adjustment expense and expense ratios were developed based on data from the years 2001 through 2005. For an effective date of July 1, 2007, basing rates on data through 2005 would have complied with the standard actuarial practice of using the most recent developed data. The MPIUA, however, chose to make its filings without the information necessary to determine a reasonable net cost of reinsurance. Had it selected a filing date that would have allowed it to incorporate an appropriately determined net cost of reinsurance, the 2006 data would have been available, and would have shown that the MPIUA's loss experience for that year was better than in 2005.[15]

We find that the MPIUA chose filing and implementation dates that were inconsistent with its obligation to present relevant information sufficient to support its proposed rates. By submitting rate filings based on inadequate or inappropriate data, the MPIUA has failed to meet its burden of proof.

2. The statutory constraints on MPIUA Rates.

G.L. c. 175C, §5 (c) sets out the requirements for review of MPIUA rates. The MPIUA asserts that the goals of its rate filings are to ensure that its rates are higher than those prevailing in the voluntary market, and that its members will not be assessed to

[13] Actuarial witnesses for the MPIUA and the Attorney General agreed that future projections should be based on data from recent years.

[14] Paul Ericksen, MAAA, FCAS, an actuarial consultant associated with the Insurance Services Offices ("ISO"), who supervised preparation of the MPIUA filings, testified that he worked on the filings in January and February 2007. He stated as well that he looked at the 2006 data in late March or April but did nothing with it. The SRB is concerned that requiring the MPIUA to use 2006 data is tantamount to treating rate filings as "moving targets." The issue is not the need to set a cut-off date for data to be used in ratemaking, but whether it is reasonable to select a timetable that produces filings that do not demonstrate that the net cost of reinsurance is reasonable and sidestep, for no adequate reason, the use of the most recent data that would be available if the MPIUA had not chosen to file prematurely.

[15] The MPIUA did not propose to alter the effective date, amend its filing to reflect newly available 2006 data, or explain why it would be appropriate to base a rate for a later policy period on 2005 data. The effect of the MPIUA's use of older data could be significant; Mr. Golembeski testified that the MPIUA made a profit of $48 million in FY 2006 (September 1, 2005 through August 31, 2006), because of favorable loss ratios for that year. That profit was $15 million higher than the MPIUA's profit for FY 2005. As of the date of his prefiled testimony, March 14, 2007, Mr. Golembeski was aware that the MPIUA's 2006 loss experience had improved over 2005.

cover any potential MPIUA deficits. It offers no statutory or other legal support for these goals.[16]

In 1996, the legislature enacted amendments to G.L. c. 175C, §5 (c) ("§5 (c)") that imposed a capping mechanism on MPIUA rates. That mechanism linked increases in MPIUA rates in large share territories to voluntary market rate increases statewide.[17] The statute established a formula for determining the rate cap, limiting MPIUA rate increases to the average statewide rate increases charged for homeowners insurance by the ten insurers with the largest market share on a statewide basis.[18] The 2004 amendments to §5 (c) authorized the Commissioner, notwithstanding the cap, to "consider the effects of predicted hurricane losses and the cost of catastrophe reinsurance on the rates charged by voluntary market insurers, and the cost of catastrophe reinsurance and the predicted hurricane losses on the association." The *Decision on the 2005 Filing* concluded that the 2004 amendments authorized approval of rates in large share territories that exceeded the rate cap based on voluntary market increases, but that the statutory language required that any such increases be based solely on predicted hurricane losses and the cost of reinsurance.[19] The MPIUA proposes rate increases in large share territories this year that again exceed the rate cap.

Section 5 (c) specifically mandates a two-pronged approach that examines "the **effects** of predicted hurricane losses and the cost of catastrophe reinsurance **on the rates** charged by voluntary market insurers, and the **cost** of catastrophe reinsurance and the predicted hurricane losses on the association." (emphasis added.) The statute, as it did before the 2004 amendment, links MPIUA and voluntary market rates, requiring consideration of the effects of predicted hurricane losses and reinsurance costs on

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[16] To the extent that the statute addresses this issue, it supports a conclusion that the legislature did not intend the MPIUA's rates to be higher than the prevailing rates in the voluntary market. Section 5 (c) provides that the Commissioner may disapprove the MPIUA's proposed rate for a small share territory if it exceeds a rate equal to the 90th percentile of the rates then in use in the territory by the ten insurers with the largest market shares of homeowners insurance in Massachusetts, on a statewide basis.

[17] 1996 Mass. Acts and Resolves, Chapter 93.

[18] The statewide average increase was calculated on a calendar year basis, and compared increases for the most recent calendar year prior to the MPIUA filing to the year before that. In its homeowners' filing, the MPIUA calculated the capped limit on rate increases for homeowner's (HO-3) policies in large share territories at 3.4 percent. No party contested that calculation.

[19] The Supreme Judicial Court affirmed the Commissioner's interpretation. *Attorney General v. Commissioner of Insurance*, 450 Mass. 311, 318-323 (2008).

voluntary market rates and the cost of those components to the MPIUA.[20] Although §5 (c) does not prescribe a formula for quantifying that relationship or set a particular standard for comparing them, it reflects an understanding that the MPIUA does not operate in a vacuum but, rather, is part of a larger industry.[21] The legislature's approach, by requiring examination of the effect of potential losses from natural disasters, such as hurricanes, and of the cost of ceding such losses, on rates in both the voluntary and residual markets, recognizes that the occurrence risk of such events is identical for all insurers, and that considerations that support the purchase of reinsurance apply to both markets.[22]

By drawing a distinction between the **effects** of predicted hurricane losses and the cost of catastrophe reinsurance **on the rates** charged by voluntary market insurers, and the MPIUA's **cost** of catastrophe reinsurance and hurricane losses, the statute does not limit the MPIUA's rate changes resulting from those two factors to the level of change in the voluntary market. The MPIUA's burden is to provide a comparison point for evaluating its rate factors and to demonstrate that the reinsurance costs and estimated values for hurricane losses in its filings produce rates that are within a range of reasonableness.

The MPIUA, in preparing its filings, considered some aspects of the relationship between its reinsurance purchases and those of its member companies, and the models that its members use to develop hurricane losses in their rate filings.[23] The MPIUA did not, however, offer any evidence of the effects of those elements on voluntary market insurance rates.[24]

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[20] The legislative link is manifest also by the additional requirement in §5 (c) that, when a territory newly qualifies as a large share territory, the MPIUA must analyze the voluntary market rates in that territory and report the result to the Commissioner. She then either re-certifies the MPIUA's rate or approves a revised rate that is related to the voluntary market rates in the territory.

[21] See, e.g., G.L. c. 175C, §4 (b), which requires the Commissioner, in reviewing the rates for the MPIUA, to consider the loss experience of insurers in the voluntary market, as well as the MPIUA's experience, in addition to all other relevant factors.

[22] Estimates of hurricane losses and the cost of reinsurance will vary, of course, depending on the insurer's book of business and the structure of its reinsurance program. For voluntary market insurers, risks may include the possibility of assessments to satisfy any MPIUA deficits. Comparative risks will also differ depending on the concentration of exposures in areas that are exposed to hurricanes.

[23] The record is less than clear about the MPIUA's practices with respect to obtaining information about reinsurance programs and costs of its members.

[24] Mr. Ericksen testified that in connection with the proceeding on the 2005 filing he had looked at filings by the largest insurers in Massachusetts and that some of those filings provided information on reinsurance costs and hurricane provisions. He did not conduct a similar study this year.

Information on both the effects on voluntary market rates and the costs to the MPIUA provides a basis for the analysis required by statute. The MPIUA also must demonstrate that its values for the net cost of catastrophe reinsurance and predicted average annual hurricane losses are reasonable.[25] The record in this proceeding is insufficient to enable us to consider the effects of hurricane losses and the cost of reinsurance on voluntary market rates, and to evaluate or compare those effects to the cost of reinsurance or estimates of hurricane losses that the MPIUA incorporates into its rate filings. The MPIUA has not met its burden of proof under §5(c).

III. Conclusion

We find that the MPIUA failed to meet its burden of proof in this matter. It submitted its filings prematurely, without engaging in any meaningful process to determine the net cost of its reinsurance. As a consequence of that decision, its filings were not based on the MPIUA's most recent available data on its losses and expenses. The MPIUA also failed to provide the information necessary to enable the Commissioner to comply with the statutory mandate to consider the effects of hurricane losses and the cost of reinsurance on voluntary market rates and MPIUA's costs of such losses and reinsurance.

[25] Our observations on the filings are contained in the Appendix to this Decision and Order.

We therefore disapprove the MPIUA's 2007 Rate Filings.[26] The MPIUA may submit new rate filings that comply with this Decision and Order. A hearing on any such filings will proceed on an expedited basis and be conducted day-to-day.

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Stephen M. Sumner Jean F. Farrington

I have reviewed the record and the decision of the presiding officers and approve their findings and conclusions.

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Nonnie S. Burnes
Commissioner of Insurance

Dated: May 8, 2008

This decision may be appealed pursuant to G. L. c. 30A.

Appendix

[26] On October 4, the Attorney General moved to sanction the MPIUA for failure to comply with discovery. In light of our decision in this proceeding, the motion is moot.