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Opinion, Findings and Decision on
The Hanover Insurance Group's
Private Passenger Motor Vehicle Rate Filing
Dated November 27, 2007

Docket No. R2007-08

I. Procedural Background

On November 19, 2007, the Hanover Insurance Group ("Hanover") submitted for my review a filing for private passenger motor vehicle ("PPMV") insurance rates pursuant to G.L. c. 175E ("c. 175E"). In accordance with 211 CMR 79.19, Hanover amended its filing on November 27. On December 17, 2007, the Attorney General, pursuant to c. 175E, §7, moved for a hearing on Hanover's filing, alleging that its rates were excessive. On December 18, I issued a notice for a hearing to commence on January 16, 2008. The notice informed the parties that the hearing would cover the Attorney General's allegation that Hanover's proposed rates are excessive, in violation of G.L. c. 175A and c. 175E, specifically because of: 1) the cost of capital, including calculation of the internal rate of return model, leverage ratios, asset returns and cash flows; and 2) the inclusion of contingent commissions in the expense provision.

The hearing occurred on January 16. James R. Merz, FCAS, MAAA and Katherine Barnes, FCAS, MAAA testified on behalf of Hanover. Allan I. Schwartz, FCAS, MAAA was the witness for the Attorney General.[1]

II. Standard of Review and Burden of Proof

Commissioners of Insurance have determined that conditions in Massachusetts were such that rates should be fixed-and-established industrywide for PPMV insurance for the past 30 years. On July 16, 2007, after a hearing was held as in past years, I concluded that sufficient competition existed in the PPMV insurance market such that it was not necessary to fix-and-establish these rates (the "*July 16 Decision"*). The Division of Insurance ("Division") then promulgated 211 CMR 79.00 *et seq*., to govern the requirements for rate filings for PPMV insurance rates in a competitive market. The 19 insurers currently writing this line of insurance submitted to the Division individual rate filings pursuant to c. 175E and G.L. c. 175A, with effective dates of April 1, 2008.

Chapter 175E, §4 mandates that "[r]ates shall not be excessive or inadequate, as herein defined, nor shall they be unfairly discriminatory." It further provides that '[n]o rate shall be held to be excessive unless [it] is unreasonably high for the insurance provided" and that evidence "that a reasonable degree of competition exists in the area with respect to the classification to which such rate is applicable shall be considered as material, but not conclusive evidence, that such rate is not excessive." My task under c. 175E is to determine whether a company's proposed rates satisfy the statutory and regulatory standards.[2]

I may not disapprove rates if they fall within a range of reasonableness, and otherwise satisfy the requirements of the general laws. *Attorney General v. Commissioner of Insurance*, 450 Mass. 311 (2008). I do not set the rates under c. 175E. My authority is limited strictly to disapproving a rate or, under very limited circumstances set forth in the statute, approving it. I look at the proposed overall rates generated by the rate filing viewed as a whole to determine whether a company's

[1] On Hanover's motion, prefiled testimony from two proposed witnesses for the Attorney General, Stacey Gotham, FCAS, MAAA and Birny Birnbaum, was stricken on the ground that each witness addressed matters that were not at issue in this proceeding.

[2] The Attorney General alleges only that Hanover's proposed rates are excessive. That is the sole standard that I am adjudicating.

proposed rates are excessive for the insurance provided. I also consider whether the proposed rates are generated using generally accepted actuarial approaches to ratemaking. 211 CMR 79.05(5).

Chapter 175E, §7 allows the Attorney General to request a hearing on a rate filing. The rate filer has the burden of proving that its filing complies with c. 175E, G.L. c. 175A, and 211 CMR 79.13(11). Challenges to particular aspects of the rate filing are insufficient, *per se*, to demonstrate that an overall rate does not meet statutory standards. Contrary to the Attorney General's assertion, a company's rate is not necessarily excessive if one component of it is excessive. It is possible that a component of a rate may be excessive but that the overall rate may be within a range of reasonableness after all the other components are factored together. For example, an inadequate component could neutralize an excessive component, resulting in a reasonable rate.

The Attorney General contends that her task in c. 175E, §7 hearings is to ensure that filings provide fair and reasonable rates. Achieving that goal requires a "fair" hearing that, she avers, includes meaningful review of rate filings, discovery of insurers' data, and investigation of "all pertinent issues." She asserts that a separate standard applies to her review, but neither explains the relationship between her stated mission and the statutory standard for reviewing c. 175E rate filings, nor reconciles the concept of "reasonable" rates with the premise that rates must fall within a range of reasonableness.

The Attorney General argues that this §7 hearing was neither full nor fair. She complains that "time periods were truncated, discovery prohibited, subpoenas vacated, subjects excluded and testimony struck." Her discontent, however, arises from her misapprehension of the premise of this hearing and the burden of proof. She overlooks that in my role as the regulator I only can review compliance of Hanover's filing with statutory standards rather than explore alternative approaches. Indeed, the Attorney General bears no burden of proof and has no role in establishing a different rate for Hanover. See our Order *on Attorney General's Motion for Discovery*, dated January 3, 2008. The record of this proceeding, including arguments and orders on the motions made by the parties, speaks for itself. The rulings and orders are consistently cognizant of the overall scope of this proceeding, of the specific limits on the disputed issues as set out in the Attorney General's initial request for a hearing, and of the time constraints

engendered by the need to have new rates in place within a time frame that will maximize the benefit to consumers of managed competition and discounted rates.[3]

III. The Substantive Issues

A. Material Evidence of Competition

Section 4 of c. 175E provides that: "[e]vidence that a reasonable degree of competition exists in the area with respect to the classification to which such rate is applicable shall be considered as material, but not conclusive, evidence that such rate is not excessive." Hanover argues that my finding in the *July 16 Decision* that competition exists in the market satisfies this criterion and supports a finding that Hanover's rates are not excessive. Hanover also cites to specific conditions within the market and certain products offered by companies to further support this argument.

The testimony of Ms. Barnes highlights the competitiveness of the rates among the companies, particularly post November 27 when the companies filed amended rates with additional rate discounts. Ms. Barnes further stresses that the addition of a host of new rating variables and factors, such as refined discounts or rating factors for years of driving experience and good student discounts, constitute material evidence that Hanover's rate is not excessive. She further cites new coverages and programs, such accident forgiveness programs and the elimination of the short rule in certain instances, as additional indicia of competitiveness. Finally, she notes the addition of a new entrant to the PPMV insurance market, which has not happened in decades.

The Attorney General, in a footnote, argues that Ms. Barnes's testimony should be discounted fully. She states that Ms. Barnes's review of all of the companies' filings was cursory and that she failed to analyze the factors and inputs that typically comprise a true economic analysis of competition within a market.

[3] The time sensitivity of this proceeding is extraordinary. It occurs within the context of the change from a fix-and-establish system to a managed competition system in approximately eight months. The schedule was set in accord with the provisions of 211 CMR 79.11 and 79.12, which impose express timelines for proceedings on c. 175E rate filings. The rates filed on November 19 and amended on November 27 are to take effect on April 1, 2008, when the current fix-and-establish rates applicable to all insurers, including Hanover, expire by operation of law. Companies require timely decisions in order to reprogram computer systems and generate the renewal notices that companies must send to policyholders 45 days before a policy expires under the law (*i.e.*, February 15 for April 1 renewals). These regulatory procedures were tailored to ensure timely completion of this proceeding.

Discussion and Analysis

My *July 16 Decision* speaks to competition generally rather than to the specifics that appear to be required under c. 175E, §4, and provides meager support for Hanover's argument that my decision, alone, satisfies this statutory criterion. Hanover does provide some independent evidence to demonstrate the existence of competition to satisfy this criterion through the testimony of Ms. Barnes.

I do not find that Ms. Barnes's testimony should be discounted as suggested by the Attorney General. Ms. Barnes reviewed all of the rate filings in our market and compared them by product and price. That she did not conduct a literal economic analysis is only of limited import. Her findings are objective and helpful in determining that competition in our market exists with respect to certain classifications. The introduction of many new products and rating variables constitutes some indicia of competition within certain classifications. While this finding is not dispositive of the issues in this case, it does present material evidence that Hanover's rates are not excessive.

B. Underwriting Profits

Mr. Merz testified that Hanover's rate filing was based on reasonable selected inputs utilized within sound actuarial methodologies that produced reasonable outcomes. He stated that Hanover used historical data and informed business judgment about likely future events to develop an underwriting profits provision for the rate effective period. Mr. Merz opined that the rate filing is appropriately supported, and stated that it fully complies with the applicable regulatory requirements and guidance.

Mr. Merz testified that Hanover's underwriting profit provision utilizes an internal rate of return ("IRR") model that Actuarial Standard Of Practice ("ASOP") No. 30, Appendix 1 specifically recognizes. He described the general terms of Hanover's IRR model, highlighting the specific pages of the company's filing that documents the methods and assumptions in that model. Mr. Merz observed that ASOP No. 30 states that the cost of capital is likely to vary among insurers. He explained that the 15 percent implied cost of capital in Hanover's underwriting profit provisions is based on statutory accounting and reflects its judgment about the opportunity cost of allocated capital in all

states in which its does business, including Massachusetts. He emphasized that other states in which Hanover writes PPMV insurance have accepted that value in its filings.

Mr. Merz stated that the premium-to-surplus ratio in Hanover's IRR model is within the range of reasonable values that he has observed and used in other states. Hanover's asset returns, developed in consultation with its chief investment officer and finance and actuarial staff, reflect what it expects to realize during the policy effective period. Miscellaneous income similarly reflects revenue that the company expects to earn during that period. Mr. Metz further stated that Hanover's tax rate is consistent with prior history. He points out that Hanover's underwriting profit provisions produced an indicated rate (-5.4%) that, while lower than 2007 rates, is higher than the company's proposed rates (-8.1%). Hanover chose to file rates significantly lower than its indicated rates for competitive reasons.

The Attorney General alleges that the profit provisions in Hanover's rate filing are "unreasonable and excessive," and "substantially" higher than the profit permitted in prior rate decisions and than any profit provision charged by an automobile insurance company in Massachusetts for at least the last 25 years. Specifically, she asserts that Hanover has not supported or justified the after-tax rate of return, value of miscellaneous income, and tax rate that it used as inputs in its underwriting profits provision.[4] The Attorney General characterizes Hanover's target rate of return as arbitrary and not based on a data source or supported by a calculation and similarly asserts that Hanover did not support its miscellaneous income value. The lack of documentation, she argues, is inconsistent with ASOPs 9 and 41.

Mr. Schwartz compared Hanover's underwriting profit provision to what it would have been if it were calculated using values from the Commissioner's *Decision on 2007 Rates.* The Attorney General argues that it is appropriate to use those values because they are supported by clearly identified data sources and methods adopted by a previous Commissioner. She further asserts that these values were intended to represent competitive market profit, and are appropriate for a line of insurance that is less risky than other lines of property/casualty insurance. Mr. Schwartz also increased Hanover's

[4] Miscellaneous income consists of installment plan fees, returned check fees, and various other transactional fees.

value for its miscellaneous income after examining the most recent available data on such income that Hanover had provided to the Automobile Insurers Bureau ("AIB").

Discussion and Analysis

The Attorney General principally opposes Hanover's proposed rates because the cost of capital it used to develop its underwriting profits provision differs from that used in the 2007 fix-and-establish rate decision. She also asserts that the company has failed to change its Massachusetts finance charge plan to conform to its estimates of finance charge income during the policy effective period. The Attorney General's invocation of the 2007 fix-and-establish rate decision and the industrywide profit provision selected by the Commissioner in the decision is misplaced. Past fix-and-establish decisions are irrelevant to this proceeding which is conducted pursuant to c. 175E and G.L. c. 175A rather than G.L. c. 175, §113B. This proceeding differs fundamentally from a proceeding to fix-and-establish industrywide insurance rates. My review of a company's rate filing is based primarily on the company's own data and the methodologies that it chooses to implement. It is not my task to look at aggregate industrywide data to develop an underwriting profits provision that reflects the average financial needs of a mythical "Every Company," but is specific to none.

In c. 175E filings, a company must develop a profits provision that reasonably reflects its financial needs and that, when included in its proposed rates, produces an overall rate that complies with the statutory standards and produces competitive rates. In a competitive market, companies are free to incorporate their own target profit provisions into their proposed rates; price competition is expected to exert pressure on rates and to provide some control on target profit levels. Differences are to be expected between profit provisions developed for an entire industry in a fixed-and-established system and those developed for individual companies in a competitive market.

That Hanover's underwriting profit provision would be lower if it were based on industrywide input values from a prior rate decision, or that its methodologies differ from those adopted in prior fix-and-establish decisions does not demonstrate that its rates are excessive. The issue is whether Hanover's profit provision is developed using generally accepted actuarial principles and falls within a range of reasonableness. I find that it satisfies both standards.

The Attorney General's argument that Hanover's return on equity goal is undocumented and that its alleged failure to support that element of its filing is inconsistent with ASOP is not persuasive. She contends that Hanover's filing does not comply with ASOP No. 9, sections 5.2 and 5.3 and ASOP 41 because it lacks sufficient clarity to enable another actuary practicing in the same field to evaluate the work and appraise its reasonableness and validity.[5] Mr. Schwartz's testimony, however, demonstrated that no such omission prevented him from performing his own calculations after looking at Hanover's filing. Hanover, furthermore, aptly responds that its rate filing is not an actuarial report and, therefore, is not technically subject to ASOPs. ASOPs may be used for guidance but filers need not adhere strictly to them. Failure to comply with certain ASOPs does not render a rate filing excessive.

Even if ASOP 41 were to be applied, Hanover maintains that it meets the criterion. ASOP 41 provides that: "Law, regulation, or another profession's standards may prescribe the form and content of a particular actuarial communication (such as a preprinted government form). In such situations, compliance with the applicable law, regulation, or standard, and with any practice-specific ASOP governing the actuarial services that are the subject of the actuarial communication shall be deemed compliance with this standard." I agree with Hanover's conclusion that compliance with the Division's regulation satisfies this standard. Mr. Merz testified that Hanover appropriately developed its underwriting profits provision based on estimates that reflect reasonable expectations for the period in which the filed rates will be effective. He opined that its filing fully complies with the applicable regulatory requirements. The Attorney General objects to Hanover's chosen numerical values and supplants them with her own, which Mr. Schwartz "cherry picks" from the 2007 fix-and-establish decision to arrive at a lower cost of capital element. The industrywide data from this prior fix-and-establish decision is not relevant. And, as emphasized by Hanover, Mr. Schwartz did not do the same with Hanover's leverage ratio. Indeed, had he done so, Hanover's proposed rate would have increased. I agree with Hanover that Mr. Schwartz's methodology is not only irrelevant, but result oriented.

[5] That same standard appears, in almost identical form, in ASOP 41, which addresses actuarial communications.

No evidence suggests that it is unreasonable to select a cost of capital that reflects historical data and informed business judgment.[6] Mr. Schwartz testified that the cost of equity and of debt vary among companies and change over time, and that the cost of capital that he used in his calculations did not reflect 2008 rates.[7] The Attorney General's position that the provision for finance charge income in Hanover's filing is incorrect because it does not match the plan currently on file is not a sufficient basis to disapprove the filing. On this record, I find that Hanover has satisfied its burden of proof.

C. Expense Provision

Mr. Merz testified that Hanover pays contingent commissions to agents in Massachusetts, and that the expense provision in its filing reflects the costs that the company expects to incur in the rate effective period. Hanover's commission expenses include regular commissions, contingent commissions and override commissions. Mr. Merz testified that it is standard practice to pay each type of commission in Massachusetts and other states. He commented that the Casualty Actuarial Society's Statement of Principles regarding property and casualty insurance ratemaking assert that a rate is reasonable and not excessive, inadequate or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with the transfer of risk. Hanover included its expected total commission expense in its filing in accord with that principle. Mr. Merz also observed that ASOP No. 29, "Expense Provisions in Property/Casualty Insurance Ratemaking," similarly requires that rates reflect all expenses to be incurred in connection with the transfer of risk during the rate effective period, including commissions. It also, he testified, requires inclusion of contingent commissions in expense provisions unless prohibited by law or regulation,

[6] The prefiled testimony of the Attorney General's witnesses did not address several specific issues identified in her motion requesting a hearing on Hanover's filing, including the asset return value, leverage ratio, and cash flows. Mr. Merz testified on the selection of those values at the hearing. Mr. Schwartz testified that he made no different recommended values for those inputs to Hanover's IRR model. The Attorney General does not pursue those issues in her brief.

[7] The Attorney General argued in her brief that the return on equity is different from the return on capital that the Commissioner is expected to consider in evaluating rates, but offered no explanation of the significance of this alleged difference. Mr. Schwartz drew no such distinction in his testimony, which compares Hanover's return on equity value to that of the cost of capital in the *2007 Decision on Private Passenger Automobile Insurance Rates*.

which is not the case in Massachusetts. Sound actuarial methodology, therefore, requires that they be included.

Ms. Barnes testified that her review of the 19 PPMV insurance rate filings showed that all agency company filings but one included contingent commissions. Hanover argues that it would be anti-competitive for me to require it to exclude the contingent commissions because the other companies may use them.

The Attorney General argues that the commission expense provision in Hanover's rate filing is excessive because it includes a "substantial" provision for contingent commissions. Mr. Schwartz stated that Hanover's value for regular commissions was 13.8 percent, a percentage higher than that approved by the Commissioner in the *Decision on 2007 Private Passenger Automobile Rates*.

Mr. Schwartz also testified that Hanover should be precluded from including contingent commissions in the expense provision of its rates because Commissioners in prior fix-and-establish rate decisions have done so. She characterizes these commissions as a form of profit sharing that increases the already excessive profit provision that policyholders are asked to fund. The Attorney General states that contingent commissions "creat[e] serious potential conflicts of interest and lead[ing] to anticompetitive effects such as the steering of business away from more cost effective carriers." Although Mr. Schwartz testified that he agrees with the principle that a rate is an estimate of the expected value of future costs and should reflect the conditions expected during the rate effective period, he would exclude contingent commissions on the theory that they are not associated with the transfer of risk.

Discussion and Conclusion

The Attorney General does not contend that Massachusetts law prohibits or limits the payment of contingent commissions to insurance producers. She argues that including contingent commissions, as well as a higher regular commission percentage, makes Hanover's rates excessive.[8] The observation that regular commissions in Hanover's proposed rates are a higher percentage of premiums than commissions in prior

[8] The Attorney General offered no testimony or evidence to support the assertions in her request for a hearing that contingent commissions have been criticized as "creating serious potential conflicts of interest and leading to anticompetitive effects such as the steering of business away from more cost effective carriers."

rates is not *per se* evidence that the proposed rates are excessive. The crux of the Attorney General's position is that I should reject contingent commissions in a competitive market because they were disallowed in the previous fix-and-establish market. Those past decisions are irrelevant to individual company rate filings made pursuant to c. 175E.

Testimony from Mr. Merz and Ms. Barnes supports Hanover's argument that including contingent commissions in the rates is consistent both with actuarial principles of ratemaking and rate filings made by competing agency companies in Massachusetts. No evidence supports the Attorney General's argument that inclusion of contingent commissions in rates is a *sub rosa* approach to increasing the profit provision in the rates. Mr. Schwartz testified that companies account for contingent commissions as expenses and deduct them for tax purposes. Indeed, to allow the continent commission provision in the other 14 company rate filings and not in Hanover's would be unreasonable and highly prejudicial to Hanover.[9] On this record, Hanover has met its burden to show that its commission expense provision complies with generally accepted actuarial principles and does not produce excessive rates**.**

IV. Conclusion

Based on the record, I find that the Hanover Insurance Group's proposed rates comply with the statutory and regulatory standards and are not excessive. Hanover's rate filing is not disapproved.

January 28, 2008

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Nonnie S. Burnes
Commissioner of Insurance

Any person aggrieved by this decision may, in accordance with G.L.c. 175E, §13, petition for review in the Supreme Judicial Court for Suffolk County.

[9] The Attorney General requested hearings on five companies' rate filings, including Hanover's. She asserts this argument in all five proceedings. The Attorney General did not challenge rate filings by other companies that included contingent commissioner in their expense provisions. None of the rate filings from those companies have been disapproved.