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Proposed Changes to Rules 11 and 12 of the Commonwealth Automobile Reinsurers' Rules of Operation
Docket No. C2005-02.

Order on Proposed Changes to Rules 11 and 12 of the Commonwealth Automobile Reinsurers' Rules of Operation

Introduction

When a consumer applies to an insurance company for a private passenger motor vehicle liability insurance policy, the insurance company typically reviews the application and runs a model on the applicant's potential for losses (known as underwriting). The insurance company then decides whether it is profitable to retain the policy. If the company decides that the consumer's business likely would not be profitable, it may cede (transfer) the risk associated with the policy to the private passenger automobile residual market plan known as the Commonwealth Automobile Reinsurers (hereafter referred to as "CAR") rather than retain it.[1] The consumer may not know that the policy has been ceded because it still is written by the company and it bears the name of the company that has decided to cede the policy. However, the premium and losses from this ceded policy are pooled and shared among all insurance companies that write private passenger automobile

[1] Exceptions to this general rule exist. A consumer is not guaranteed private passenger motor vehicle liability insurance if, for example, he has failed to pay any of the premiums due to his insurance carrier for the past twelve months, or if he does not hold, or is not eligible to hold, a driver's license. See G.L. c. 175, §§113H (A)(1) and 113H (A)(2).

liability insurance in Massachusetts, all of which are "member companies" of CAR.[2] Thus, each member of CAR has a share of the residual market deficit.

Rules 11 and 12 of CAR's Rules of Procedure ("CAR's Rules") contain provisions that regulate the residual market by providing penalties and incentives designed to avert untrammeled growth of the residual market and avoid disproportionate representation in the residual market by any territories or driver and statistical classes. Unlike many of CAR's Rules, which do not change from year to year, Rules 11 and 12 are reviewed annually.[3] By their own terms, the provisions of the current Rules 11 and 12 expired on December 31, 2004.[4]

Procedural History

At its meeting of March 9, 2005, the Governing Committee of CAR voted to amend CAR Rules 11 and 12 by deleting and adding language to those Rules. These changes and additions were indicated on attachments to *Bulletin No. 799, Proposed Changes to Rules of Operation*, which was issued by CAR on March 29, 2005.

Bulletin No. 799 stated that a copy of the Filing Letter, which contained an explanation of the proposed CAR Rule changes, and a copy of the proposed changes to CAR Rules 11 and 12 was furnished to every member company, the two associations of insurance producers, and the Public Protection Division of the Office of the Attorney General, as is required by Article X of CAR's Plan of Operation.

On April 4, 2005, Arbella Mutual Insurance Company, Commerce Insurance Company and Plymouth Rock Assurance Corporation each timely requested a public hearing, as is provided by Article X of CAR's Plan of Operation.

On April 27, 2005, pursuant to the provisions of CAR's Plan of Operation adopted in accordance with G.L. c. 175, §113H, a Notice of Hearing was issued by Commissioner of Insurance Julianne M. Bowler, such hearing to be held on May 31, 2005 at 10:00 a.m. at the Division of Insurance ("Division"). This hearing afforded all interested parties an opportunity to provide oral and written testimony regarding the proposed amendments to CAR's Rules 11 and 12. The Notice of Hearing provided that any person who wished to

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[2] See Article I of CAR's Plan of Operation.
[3] See the testimony of Michael J. Trovato, Executive Vice President and treasurer of CAR, document #16 in the record.
[4] See the testimony of Ralph A. Iannaco, President of CAR, document #15 in the record.

testify concerning the proposed amendments was requested to submit to the Division a Notice of Intent to Testify no later than May 27, 2005.

Thirteen persons testified at the May 31 hearing.[5] Written testimony was submitted by all of these persons and also by persons who did not speak at the hearing.[6] At the close of the testimony, June 20 was announced as the date upon which the record would close. Several insurance companies filed written post-hearing testimony within this time period.[7] Furthermore, following a timely request for an extension of time for the docket to remain open, the record was ordered to be kept open indefinitely. *Ruling on Request for Extension of Time*, filed June 20. Thereafter, the record was ordered to be closed on July 29. *Order: Closing of the Record*, filed July 15, 2005. Prior to the closing of the record, several insurance companies filed additional testimony or arguments,[8] CAR submitted additional testimony and Cara M. Blank, FCAS, AAA, a Property & Casualty Actuary, filed her written testimony on behalf of the Division.

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[5] In the order of their appearance, oral testimony was provided by Ralph A. Iannaco, President of CAR; Michael J. Trovato, Executive Vice President and Treasurer of CAR; Joseph J. Maher, Jr., Vice President, General Counsel and Secretary of CAR; John F. Donohue, Chairman and Chief Executive Officer of Arbella Insurance Company; James A. Ermilio, Senior Vice President and General Counsel of The Commerce Insurance Company; Hal Belodoff, President of Plymouth Rock Assurance Corporation; Andrew J. Carpentier, Chief Operating Officer for Encompass Insurance Company; Edward N. Patrick, Jr., Vice President Underwriting of Safety Insurance Company; Robert P. Suglia, Senior Vice President and Assistant General Counsel for Amica Mutual Insurance Company; William J. Cahill, Jr., Vice President and Group Counsel for The Hanover Insurance Company; Richard Welch, President and Chief Executive Officer of The Premier Insurance Company of Massachusetts and Chair of the Actuarial Committee of CAR; Donald Baldini, Assistant Vice President and Senior Legislative Counsel for Liberty Mutual Group; and James T. Harrington, Executive Director of The Massachusetts Insurance Federation for The Coalition for Auto Insurance Reform.

[6] In addition to the written testimony filed by those who spoke at the hearing, written testimony, in the order of their filing, were submitted by David H. Cochrane, Senior Vice President - Underwriting of The Commerce Insurance Company, and by Michael Broll, Assistant Vice President - Property and Casualty Insurance, and John Friedman, Assistant Vice President and Senior Legislative Counsel - Northeast Government Relations, of USAA Group.

[7] In the order of their filing, written testimony was submitted by Plymouth Rock Assurance Corporation (two additional statements), Arbella Insurance Group, The Commerce Insurance Company, OneBeacon Insurance, Hanover Insurance and Safety Insurance Company.

[8] In the order of their filing, written testimony or arguments were submitted by Safety Insurance Company, USAA Group, The Commerce Insurance Company and Arbella Mutual Insurance Company.

PART I: RULE 11

CAR's Rule 11 Proposal

Rule 11 of CAR's Rules of Operation (hereafter referred to as "CAR's Rules") seeks to avert overuse of the residual market plan by providing a penalty for ceding exposures to CAR.[9] The disincentive is in the form of a multiplier, known as the "K-factor," that has the effect of increasing a carrier's share of the residual market losses and expenses by some numerical "factor" each time an exposure is ceded to CAR. The K-factor has been set by CAR at four for all exposures ceded to CAR since the inception of this disincentive in 1992. Thus, since voluntarily retained exposures also count towards a carrier's share of the CAR deficit, the current Rule 11 has the effect, through the mechanism of the K-factor, of increasing a carrier's deficit share by increasing the market share value of a ceded exposure by 300%.

CAR in *Bulletin No. 799, Proposed Changes to Rules of Operation*; proposes some continuity and some change to CAR's Rule 11. CAR proposes to use a 0.33 adjustment factor for motorcycles, electric cars, snowmobiles and antique vehicles, as it has for the last several years. It also proposes inexperienced operator and Safe Driver Insurance Plan ("SDIP")[10] class exclusions, as it has in the past. In a change from previous years, however, CAR proposes to depart from the current and traditional rule in

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[9] Section 113H (A) (para. 2) of General Laws chapter 175 provides that the residual market plan "shall provide for the fair and equitable apportionment among such insurance companies of premiums, losses or expenses, or any combination thereof." Section 113H (D) (para. 2) of General Laws chapter 175 provides as follows:

> The plan shall provide that the allocation of premiums, losses and expenses among companies for all policies issued during the first year of operation of the plan shall be based on the total number of risks written by each company during the calendar year nineteen hundred and eighty-two, excluding risks written through designated producers. Adjustment and consideration may be given to those companies that, due to percentage of business ceded during the base year, fall at either extreme as a result of this method of allocating premiums, losses and expenses under this plan. For policy years thereafter, the allocation shall be based on a method so that no company materially or substantially reduces its percentage of participation by reducing its writings, nor shall any company have their participation materially or substantially increased because of the action of other companies.

Section 113H (E) (para. 7) of General Laws chapter 175 provides as follows:

> The rules for such plan shall require that separate statistical data be recorded for risks insured in the plan and may provide incentives and penalties to prevent abuse of such plan.

[10] The Safe Driver Insurance Plan is authorized by G.L. c. 175, §113B.

which all business is subject to the same K-factor. Rather, CAR proposes a K-factor of one for ceded exposures from Exclusive Representative Producers[11] ("ERPs") that have a three-year cumulative calendar/accident year incurred loss ratio of greater than 125% (hereafter referred to as "HLR ERPs"), subject to minimum production requirements, and a K-factor of four for all ceded business from voluntary producers and from ERPs that have a three-year cumulative calendar/accident year incurred loss ratio of less than 125%. Furthermore, CAR proposes a cap on the ceding of exposures originating from HLR ERPs, allowing a member company to cede only up to 100% of its prior year direct exposures from HLR ERPs. Once a member company has ceded exposures originating from HLR ERPs in a number equal to the cap for that company, a K-factor of four (rather than one) will be applied to any further exposures ceded by that company from HLR ERPs during that year.

CAR stated[12] that its Actuarial Committee determined that multiple K-factors would control the size of the residual market, while also affording some relief to those Servicing Carriers with more than their fair share of HLR ERPs. In deciding upon its proposal for multiple K-factors, CAR reviewed several analyses, including cost-to-cede/cost-to retain, ERP cost per voluntary exposure, and others, in an attempt to arrive at equity, and analyzed K-factor values of zero, one, two and three. The goal, CAR asserted, was to identify a K-factor for HLR ERP business that would balance the cost-to-cede and cost-to-retain in light not only of resulting deficit costs, but also retained experience. A K-factor of zero also was considered, but it was determined that such a K factor likely would result in an increase in the size of the residual market pool.[13] CAR believed that a K-factor of one would equalize the costs of ceding and retaining exposures produced by HLR ERPs, which would, CAR felt, in turn reduce the incentive to cede that business. Moreover, in order to further lessen concerns that such a low K-factor would increase the

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[11] An ERP is a producer who does not have a voluntary contract with any insurance company and, therefore, is assigned by CAR to a servicing carrier.

[12] See the testimony of Michael J. Trovato, Executive Vice President and treasurer of CAR, document #16 in the record.

[13] A K-factor of zero would mean that the ceded exposure would disappear completely from the determination of a carrier's share of the CAR deficit. A K-factor of one would mean that a ceded exposure would count towards a carrier's share of the CAR deficit to the same extent that a voluntarily retained exposure would.

size of the pool, CAR adopted a cession cap whereby a Servicing Carrier would be prohibited from ceding HLR ERP business with an applied K-factor of one in excess of the number of its ceded plus retained HLR ERP business from the prior calendar year. CAR therefore crafted its proposed Rule 11 with a proposed K-factor of one, with a cession cap, for exposures originating from HLR ERPs.

CAR states[14] that the cap on cessions with regard to the HLR ERP business was proposed in an effort to prevent the gaming of the system. CAR notes that the Governing Committee will continue to monitor the market and move quickly if servicing carriers engage in such behavior, which a minority of Governing Committee members caution is likely to happen.

Although CAR asserts that its proposed K-factor of one for HLR ERP exposures recognizes and addresses the skewed distribution of HLR ERPs and the need to restore equity among carriers, CAR testified that a physical redistribution of HLR ERPs would be the fairest and most accurate solution to the problem of the inequitable distribution of the residual market burden. However, because of pending Superior Court litigation,[15] CAR stated that the multiple K-factor approach in proposed Rule 11 was the next best alternative to a physical redistribution.[16]

With regard to the issue of fighting fraud, CAR noted that its recent audits of Servicing Carriers did not indicate that ceded business was handled any differently from voluntary business, and therefore that fraud fighting efforts should not be impacted by a lower K-factor for HLR ERP business. Furthermore, CAR commented that it would notice any reduction in fraud fighting efforts, and that such behavior by a carrier would constitute non-compliance by that carrier with CAR's Performance Standards.

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[14] See document #45 in the record.

[15] *The Commerce Insurance Company, et al. v. Commissioner of Insurance, et al.,* Suffolk Superior Court, C.A. No. 05-0032.

[16] Several companies have argued in favor of a physical redistribution of HLR ERPs. Indeed, Commerce has proposed a physical redistribution of HLR ERPs in its "Proposal for Comprehensive Reform to Private Passenger Auto Insurance Residual Market System," document #42 in the record.

Support for CAR's Rule 11 Proposal

The Coalition for Auto Reform[17] testified that the proposed changes to Rule 11 would begin to restore equity and fairness in the distribution of the residual market burdens among companies.

OneBeacon Insurance Company ("OneBeacon")[18] argued that the lower K-factor for HLR ERPs would not necessarily increase the size of the residual market pool since the HLR ERP business would become "credit rich" if the proposed changes to Rule 12 were also adopted. OneBeacon argued that these changes, taken in tandem, will make it more attractive for carriers to write HLR ERP business on a voluntary basis. The credit increases of proposed Rule 12, it asserted, also would prevent certain territories from becoming overrepresented in the residual pool, as the increase in credits will foster a strong incentive to reduce cession rates in those territories. OneBeacon disputed the notion that carriers with a disproportionate share of HLR ERPs are in this predicament because of their mismanagement of claims and losses. It argued that management alone cannot possibly overcome the disadvantage of having a disproportionate share of HLR ERPs. Reducing the K-factor for this HLR ERP business would, it argued, result in a fairer distribution of the losses associated with this business. OneBeacon asserted that a lesser K-factor would not lead to gaming in which carriers would transfer exposures among HLR ERPs and all of their other producers. It argued that few agencies would be willing to risk their business by moving exposures to another agency in order to wash out poor quality business. OneBeacon supported the proposed changes even though it asserts that it will not be impacted by the lowering of the K-factor to one for HLR ERP business, since its share of the HLR ERP business is commensurate with its overall market share.

The Hanover Insurance Company ("Hanover")[19] argued that the proposed changes to Rule 11 are intended to control the size of the population of the plan and to partially address the inequitable distribution of the HLR ERP business among carriers. Hanover

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[17] See the testimony of James T. Harrington, Executive Director of The Massachusetts Insurance Federation, document #28 in the record.
[18] See the testimony of Robert Cordner of OneBeacon Insurance Company, document #34 in the record.
[19] See the testimony of William J. Cahill, Jr., Vice President and Group Counsel for The Hanover Insurance Company, document #25 in the record.

called the proposed amendments routine and urged approval of the proposed changes without delay.

Liberty Mutual Group ("Liberty Mutual")[20] strongly supported the proposed changes to Rule 11, asserting that the current method of distributing CAR's deficit and expenses is unfair and inequitable, and in violation of the CAR enabling statute, G.L. c. 175, §113H. Liberty Mutual argued that the proposed Rule 11 rule is a good compromise to remedy the inequitable situation.

The Premier Insurance Company of Massachusetts ("Premier")[21] stated that the proposed changes encourage rational behavior in the marketplace and result in a fairer distribution of the residual market burden than the rules that governed in previous years. Premier stated that the proposed changes would encourage carriers to write business in territories that otherwise would be overly represented in the residual market pool, and would provide relief to those carriers shouldering an unfair burden of the residual market. The varied K-factor, coupled with the changes to the credits in Rule 12, it asserted, would "go a long way" towards balancing the inequities permitted by the current and former rules and the incentives the rules created.

Amica Mutual Insurance Company ("Amica")[22] stated that the adoption of the K-factor of one for HLR ERP business and of four for other business would result in a more equitable sharing of the residual market burden among member companies. Amica asserted that some carriers are unfairly burdened with an excessive number of HLR ERPs or are required to write more than their fair share of total ERP business. Both situations result in an inequitable distribution of the costs associated with the residual market pool, Amica argued, since a carrier who is assigned an HLR ERP ends up: (1) paying higher losses on the business of the HLR ERP that it retains and (2) is charged with a greater share of the CAR deficit due to increased ceding. Allowing a K-factor of one for this business, it argued, would allow those losses associated with the HLR ERP business to be

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[20] See the testimony of Donald Baldini, Assistant Vice President and Senior Legislative Counsel for Liberty Mutual Group, document #27 in the record.

[21] See the testimony of Richard Welch, President and Chief Executive Office of The Premier Insurance Company of Massachusetts and Chair of the Actuarial Committee of CAR, document #26 in the record.

[22] See the testimony of Robert P. Suglia, Senior Vice President and Assistant General Counsel for Amica Mutual Insurance Company, document #24 in the record.

more equitably distributed among all carriers. Amica supported CAR's proposal notwithstanding the fact that it does not currently have any HLR ERPs assigned to it, and that adopting this rule change will, therefore, result in an increase to its residual market burden.

Safety Insurance Group, Inc. ("Safety")[23] stated that a carrier's residual market burden consists of two parts: (1) the company's share of the CAR deficit using the participation ratio through CAR Rules 11 and 12, and (2) the company's "stealth deficit," which Safety defines as the underwriting result (retained premium minus expenses and losses) for generally unprofitable ERP business that a company retains.[24] Safety argued that the proposed Rule 11 will finally give companies with more than their fair share of HLR ERPs relief from the cost of being forced either to retain HLR ERP business or to cede such business with a K-factor of four. Safety asserted that the higher proportion of ceded business, in combination with the K-factor of four, magnifies such a carrier's share of the deficit, inflating their participation ratio higher than their market share. Safety averred that a K-factor of zero would be appropriate for such business, which would then be treated as an excluded class of business with no cost associated with it, but acknowledged that a K-factor of one is a meaningful first step towards the fair and equitable distribution of the residual market burden.

Although proposed Rule 11 would provide an opportunity to cede more policies to the residual market at less cost, Safety argued that the CAR pool will grow only marginally larger than the current pool if the proposed changes to Rules 11 and 12 are approved. Even if companies were to cede 100% of this HLR ERP business, Safety asserted that the cession rate for the industry would rise only from 6.7% to 9.5%. Moreover, Safety argued that such an extreme likely would not occur under the proposed rules. Because a dramatic increase in the cession of HLR ERP business would increase the deficit, which would increase the penalty to cede, Safety argued that an incentive for

[23] See the testimony of Edward N. Patrick, Jr., Vice President Underwriting of Safety Insurance Group, Inc., document #23 in the record.

[24] Safety asserted that the "stealth deficit" is a result of a carrier's calculated decision to retain unprofitable business, rather than to cede it to CAR at the K-factor of four. This results, Safety asserts, in an increase in the participation ratio of such carriers and, thus, in an increase in their share of the CAR deficit. Reducing the K-factor to one for HLR ERP business, Safety argued, will allow such carriers to cede these risks without incurring the K-factor penalty and without increasing their participation ratios.

companies to retain more non-HLR ERP business would be created as more HLR ERP business was ceded. Thus, Safety argued, from a common sense standpoint, if more exposures were to be ceded from HLR ERPs, which constitute 6% of the market, then fewer would be ceded from the remaining 94% of the market. Moreover, Safety argued that the more practical outcome under the proposed rules is something less than a cession rate of 100% for HLR ERP business because (1) "the current cession rate on Exclusions is less than 100% in an environment where credits are undervalued," (2) a portion of HLR ERP business is profitable and (3) factors such as varying performance among HLR ERPs, fair credits on HLR ERP business, individual company strategies and specific company session goals will contribute to a cession rate "well below 100%." Thus, Safety estimated that 30-40% of the HLR ERP exposures will be retained under the proposed rules, which it projected to an industry cession rate of 7.3% to 7.9%, up from 6.7%.[25]

Safety asserted that proposed Rule 11 will not lead to reduced fraud fighting or an increase in gaming, since CAR's Rules of Operation and Performance Standards would deter these possibilities. Characterizing the brokering of policies between two producers for the same carrier as both illegal and unethical, Safety stated that such brokering would constitute a clear violation of CAR's Plan of Operations.

Safety argued that proposed Rule 11 does not reward companies that have a poor history of managing HLR ERP business and punishes those that have demonstrated a superior handling of that business. Rather, Safety asserted, the rule will provide a more equitable distribution of the residual market burden. Based on its analysis of the experience of Plymouth Rock and USAA (according to Safety, Plymouth Rock paid $6.6 million less than its "fair" share of the CAR deficit and USAA paid $4.8 million more than its "fair" share), Safety argues that the disparate results for these two carriers cannot be attributed to poor management by USAA, as it shares the same management principals with Plymouth Rock. Therefore, Safety concluded that the obvious reason for the discrepancy is solely the distribution of the ERPs.

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[25] See page two of Safety's Memorandum titled "Re: Safety's Analysis on Cession Rates and Size of CAR," contained in document #37 in the record.

USAA[26], pointing to the inequitable distribution of losses associated with the residual market burden, stated that the K-factors in proposed Rule 11 would mean that member companies would share in the losses created by HLR ERPs on a basis that more accurately reflects a company's share of the market:

> The current system is inequitable because exclusive representative producers (ERPs) who generate high loss ratios are inequitably distributed among the participants in the market place. . . . The proposed K factors would help to address this inequity to some degree by requiring participating insurers to share in the losses generated by these high loss agents on a basis that more closely reflects a company's share of the market. Yet, there would be no need for redistribution of agents based upon these K factor changes and, hence, no disruption to the current ERP assignments and relationships.

Support for the proposed changes to Rule 11 also was expressed by Encompass Insurance Company.[27]

Opposition to CAR's Rule 11 Proposal

Plymouth Rock Assurance Corporation ("Plymouth Rock")[28] testified that, while a need exists to remedy the current inequities in the residual market, the proposed rule would merely shift the inequities from one group of companies to another. This would occur, it asserted, because of the advantage that carriers with more HLR ERPs would enjoy with regard to the subscription formula. Plymouth Rock argued that even though there would be virtually no cost to cede HLR ERP business, the HLR ERP business would count towards the company's ERP quota for subscription purposes. Thus, Plymouth Rock asserted that the proposed changes to Rule 11 would impose a financial disadvantage on those carriers who would have to write a higher percentage of business from non-HLR ERPs. Because exposures ceded from non-HLR ERPs are subjected to a higher K-factor under the proposed rule, carriers that fulfilled their subscription quota share of ERPs with

[26] See the testimony of Michael J. Broll, Assistant Vice President - Property and Casualty Insurance, and John P. Friedman, Assistant Vice President and Senior Legislative Counsel - Northeast Government Relations, documents ##29 and 41 in the record.
[27] See the testimony of Andrew J. Carpentier, Chief Operating Officer for Encompass Insurance Company, document #22 in the record.
[28] See the testimony of Hal Belodoff, President of Plymouth Rock Assurance Corporation, document #21 in the record.

non-HLR ERP business would receive a disproportionate share of the residual market burden.

Plymouth Rock also objected to the adoption of Rule 11 as proposed on public policy grounds. It argued that the proposed rule could result in a disproportionate number of urban drivers being placed in the residual pool and could lead to the very gaming the rule was intended to remedy. Because HLR ERPs would have a lower K-factor associated with their business, Plymouth Rock contended that such producers would be highly desirable to carriers: in search of the ability to cede at the K-factor of one under its cession cap, a company could engage in the brokering of business from non-HLR ERPs to HLR ERPs. By reducing the financial penalty for ceding HLR ERP business, the companies would not engage in expensive cost containment and claims management techniques, it argued. Since reducing the K-factor for HLR ERP business actually rewards companies for failing to reduce the loss ratios of these agents in the past, rewarding carriers for failing to devote adequate resources to managing the business of HLR ERPs, Plymouth Rock argued that the proposed changes to Rule 11 are against public policy. Furthermore, Plymouth Rock alleged that reducing the K-factor for this business to a value of one virtually constitutes a “free” cede, which would increase the size of the residual market deficit by approximately $65 million, based on the assumption that virtually all HLR ERP business would be ceded and projecting the impact on the residual market deficit using 2003 CAR data.

Furthermore, Plymouth Rock stated that Rule 11, as proposed, will not work well in conjunction with the credit mechanisms in proposed Rule 12, which would result in certain territories being disproportionately represented in the pool. It asserts that this disconnect will result in the doubling of the amount of business currently ceded by urban HLR ERPs. As an alternative to proposed Rule 11, Plymouth Rock recommended the physical redistribution of HLR ERPs as the best and most equitable manner of allocating the residual market burden, and suggested that credits be taken into account when defining producers as HLR ERPs. After this redistribution, Plymouth Rock stated, the K-factor should be set at four for all business, regardless of producer type.

Arbella Insurance Group ("Arbella")[29] argued that a K-factor of one for HLR ERP business would eliminate the incentive for carriers with HLR ERPs to retain that business, while simultaneously giving those carriers credit for that business towards their proportionate share of ERP exposures. This would result in a significant growth in the CAR deficit; an increase of some $60 million dollars, according to Arbella. Since carriers are given full credit towards their ERP subscription quota for HLR ERP business, Arbella argued, the rule would encourage them to "relax" their cost containment and claims management procedures for HLR ERPs. In addition, some carriers, asserted Arbella, have a lower share of HLR ERP business because they manage the business well, using successful underwriting practices, premium collection efforts and fraud detection and claims management practices. The proposed Rule 11 would give carriers with more HLR ERPs an advantage over those companies with fewer HLR ERPs, which thereby would punish those companies who have successfully reduced losses attributed to their HLR ERPs, Arbella argued. It asserted, furthermore, that there is no incentive under the proposed Rule 11 for carriers to work with the HLR ERP to reduce its loss ratio if business ceded from these producers is essentially a free cede. Indeed, Arbella asserted that this aspect of the proposed changes to Rule 11 actually may encourage the growth of HLR ERP books of business. If HLR ERP business is to be given a K-factor of one, Arbella maintained, then that business at a minimum should not count towards a carrier's ERP subscription requirement. Arbella argued that a physical redistribution of ERPs by loss ratio must be incorporated into any plan for it to function effectively, and that the plan must ensure the carriers have the responsibility to manage the entire book of business of each ERP assigned to them.

In additional written testimony,[30] Arbella stated that what it refers to as "free" cedes for HLR ERPs in the proposed Rule 11 would, assuming that all HLR ERP exposures would be ceded with a K-factor of one and projecting the impact on the residual

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[29] See the testimony John F. Donohue, Chairman and Chief Executive Office of Arbella Insurance Group, document #18 in the record. Arbella's arguments that approving the proposed changes to Rule 11 would violate the stay imposed by the Superior Court in *The Commerce Insurance Company*, *et al. v. Commissioner of Insurance*, *et al.*, Suffolk Superior Court, C.A. No. 05-0032, are now moot, in light of the granting of summary judgment in that litigation in favor of the plaintiffs.

[30] See document #32 in the record.

market deficit using 2003 CAR data, have added another 100,000 exposures to CAR and $60 million to CAR's deficit in 2003. Arbella asserted that the same result could be expected for 2005. Arbella continued to advocate for a physical redistribution of HLR ERPs, and stated that the proposed K-factor of one would defeat the goals of assuring that proper premiums are collected, fraudulent practices detected and claims settled property and cost effectively.

The Commerce Insurance Company ("Commerce")[31] opposed proposed Rule 11 on several grounds. As HLR ERP business is composed of classes and territories with high cession rates, particularly urban communities, Commerce argued that a K-factor of one will cause companies to increase their cessions from those classes and territories. Such a result would cause those classes and territories to be disproportionately represented in the pool, in violation of G.L. c. 175, §113H, Commerce argued. Commerce estimated that the K-factor of one for HLR ERP business would increase cession rates for that business by 50%, with an estimated 29% increase in cession rates for urban territories.

Commerce also argued that the proposed definition of HLR ERPs is flawed because it does not reflect the impact of class and territory rate subsidies and redundancies, it uses outdated data even though more current data is available, and the 125% loss ratio threshold is arbitrary and does not adjust for changes in business environment, agency structure or the business strategy of an individual producer. Commerce asserted that the 125% threshold is not actuarially credible because of the small size of the books of most agencies. These defects would, in Commerce's view, lead to an increase in the number of ERPs labeled as HLR ERPs. Commerce also criticized the proposed Rule 11 as being silent as to how business would be treated for cession purposes if an HLR ERP buys a non-HLR ERP, or vice versa, which could cause confusion and uncertainty and could require new and complex business tracking procedures.

[31] See the testimony of James A. Ermilio, Senior Vice President and General Counsel of The Commerce Insurance Company, document #19 in the record, and the testimony of David H. Cochrane, Senior Vice President - Underwriting of The Commerce Insurance Company, document #20 in the record. Commerce's arguments that approving the proposed changes to Rules 11 and 12 would violate the stay imposed by the Superior Court in *The Commerce Insurance Company, et al. v. Commissioner of Insurance, et al.,* Suffolk Superior Court, C.A. No. 05-0032, are now moot. See note 29, *supra*.

Commerce further argued that the proposed Rule 11 is contrary to public policy in that it will increase the CAR deficit, create inequities among carriers, open the door to gaming, cause market disruption and require retroactive ceding. Commerce characterized the proposed rule as a way to redistribute the CAR deficit at the expense of certain carriers who have managed their business better than others. In addition, Commerce argued that the proposed changes will allow carriers to game the system by directing ceded business to HLR ERPs in order to take advantage of the lower K-factor they would enjoy since the brokering of business between producers is not prohibited. Furthermore, Commerce asserted that the lower K-factor for HLR ERPs means that carriers will have an incentive to manage business less stringently from producers who are not HLR ERPs, thereby resulting in their having higher losses, in order to convert them into HLR ERP status.

Commerce argued that the lower K-factor will likely cause CAR to submit changes to the subscription calculations which would lead to a physical redistribution of ERPs, thereby causing market disruption. It argued that nine of the existing servicing carriers would have their "ought to have" shares of ERPs adjusted by at least 10%, which would require a redistribution that would result in disruption. In addition, because the decision regarding the K-factor is being made so late in the year, Commerce argued that this rule change would result in retroactive ceding of business to CAR which would create further inequities as policies with large losses could then be retroactively ceded to CAR. This would increase the deficit, Commerce asserts.

Cara M. Blank, FCAS, AAA, a Property & Casualty Actuary who appeared on behalf of the Division ("Blank"), shared her insights and recommendations through written testimony filed in this proceeding.[32] Blank argues that in the past a variable K-factor depending on producer type has been advocated in order to allow for the run-off of certain business as the residual market transitioned from a pool to an assigned risk plan.[33] Now that the advent of an assigned risk plan is uncertain, Blank asserted that the desirability of a varied K-factor no longer exists.

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[32] See documents #46 and #47 in the record.

[33] This previous testimony had been submitted in connection with the Auto Reform Proceedings of 2004, when the Commissioner had sought to transition the residual market to an assigned risk plan.

Blank argues that using a separate K-factor for HLR ERP business will increase the overall size of the residual pool, since the K-factor of one virtually assures that 100% of all HLR ERP business will be ceded. Blank asserted that, although overall cession rates may remain close to current levels in the first year as business shifts among agencies, the cap for the following years would work off of a revised exposure total as that total would change based on the prior years writings by the producer. This would allow ceded business from non-HLR ERP agencies to shift to HLR ERPs, she asserted. This shift alone could result in an increase in the pool of 32%, so that nearly 9% of the market would be ceded within two years, according to Blank.

Blank stated that there is no incentive under the proposed changes, and in fact a disincentive arises for companies to manage HLR ERP books of business effectively so as to keep down those loss ratios. Lowering the loss ratio of an HLR ERP to below the 125% level would cost the carrier the ability to cede business at the reduced K-factor, she noted. The lower K-factor assigned to HLR ERP business, she asserted, makes those producers more attractive to carriers, so carriers would have no incentive to reduce the loss ratio of any HLR ERP assigned to it as business from those producers is a virtual "free" cede to the residual market pool. In addition, she argued, for those companies who currently do not have an HLR ERP assigned to it, but that do have ERPs with high loss ratios that verge on the 125% loss ratio that defines an HLR ERP, the incentive to prevent that producer's loss ratio from increasing disappears.

Noting that not every servicing carrier currently has an HLR ERP assigned to it, Blank asserted that the varied K-factor in proposed Rule 11 would cause an increase in the number of HLR ERPs. Because of the low K-factor for ceding this business, every company will want at least one HLR ERP so as to remain competitive with those who do have HLR ERPs, she argued.

In addition, Blank asserted, as occurred in the commercial automobile market prior to the implementing of curative changes, the lower K-factor for certain ERPs will result in the devaluation of the business of voluntary agents and non-HLR ERPs. Thus, Blank concluded, a lower K-factor for HLR ERPs will result in a shrinking market and income for non-HLR ERP agencies.

In the judgment of Blank, the proposed Rule 11 will not benefit consumers. A lower K-factor for HLR ERPs would absolve companies from their responsibilities to effectively manage such business, she argued. According to Blank, there are three reasons an agency runs a loss ratio of higher than 125%: (1) it insures a disproportionate number of poor drivers, (2) the company does not adequately manage its agencies, and/or (3) the company does not take a disciplined approach to claims handling. Although the 125% used to define HLR ERPs was chosen to distinguish agency performance issues from the influence of average rate subsidies on a reported loss ratio, Blank argued, proposed Rule 11 would encourage an even more relaxed approach to all three reasons an agency runs a loss ratio of over 125%. The lower K-factor for HLR ERP business will increase losses and rates and reduce incentives for companies to fight fraud, because it will become cheaper to cede business than to effectively manage these challenges, she asserted. Asserting that injury claims frequency from policies written by HLR ERPs is approximately five times greater than the industry as a whole, Blank stated that the higher rate of insurance losses under these policies results in higher rates for everyone else. Furthermore, she stated that, because HLR ERPs are located predominantly in urban areas, the reduced K-factor for that business could result in a disproportionate number of exposures from certain territories and classes being ceded to the pool. If all business insured in certain territories is ceded, Blank projected the overall proportion of vehicles ceded to CAR could rise to 16% from the current rate of 7%.

In conclusion, without recommending what the K-factor should be, Blank recommended adoption of a single K-factor for all business, regardless of producer type. If a more equitable apportionment of the deficit is sought, Blank argued, it should be pursued by addressing negative rate subsidies through changes to Rule 12.

Discussion and Analysis of CAR's Rule 11 Proposal

The debate over proposed Rule 11 centers on the concept of defining some ERPs as HLR ERPs and allowing business from such HLR ERPs to be ceded to CAR with a reduced K-factor.

Since 1992, the K-factor has been set at a value of four for all ceded exposures, with the exception of motorcycle and miscellaneous classes and inexperienced operator and SDIP class exclusions, without controversy or complaint. The concept of carving out HLR ERPs from the general ERP population was originally developed as part of the intended restructuring of the residual market pool to an assigned risk plan. It originated in a report prepared by Tillinghast/Towers Perrin at the Commissioner's request in April 2003 ("Tillinghast report") following its examination of the residual market[34]. Due to current uncertainty concerning whether Massachusetts will get an assigned risk plan[35], the residual market remains as it was before: a pool with a high deficit and a large number of ceded policies from certain territories and classes that are not equitably distributed among all of the servicing carriers. The inequitable distribution continues, and CAR's proposed changes to the K-factor for HLR ERPs are simply an attempt to quickly reallocate the burden in a more equitable manner. However, we believe that CAR's proposal would likely increase the size of the pool to unacceptably high levels. If it were to cost next to nothing to cede a risk, we anticipate that all high loss risks would be ceded. Equitable distribution of the losses of the residual market pool should not be achieved at the expense of increasing the population of the pool. Under proposed Rule 11 not only would a company be able to cede an exposure from an HLR ERP for a K-factor of one, but that company also would receive credit for that business towards its share of ERP exposures. This is the functional equivalent of rewarding a company for having HLR ERP exposures and then not penalizing it (or at least not adjusting for the previous reward) for ceding those same exposures. Not only is this counter-intuitive, it is as unfair as the current system is to companies that are overburdened with HLR ERPs.

As most of the HLR ERPs are located in urban areas, allowing a K-factor of one for that business would encourage the ceding of that business and thereby result in an increasingly disproportionate representation of those territories in the pool. Such an outcome flies in the face of G.L. c. 175, §113H, which requires that no class or territory be disproportionately represented in the pool. This, too, is an unacceptable result of proposed Rule 11.

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[34] Blank filed the Tillinghast report in this proceeding; see document #47 in the record.

[35] The Superior Court disposition of *The Commerce Insurance Company, et al. v. Commissioner of Insurance, et al.*, Suffolk Superior Court, C.A. No. 05-0032, currently is under appeal. Furthermore, the Governor has filed legislation that would explicitly authorize the Commissioner of Insurance to establish an assigned risk plan.

The definition of an HLR ERP, a producer whose three-year losses equal or exceed 125%, was derived from the Tillinghast report. That report concluded that, even accounting for subsidies and credits, little reason exists for an agency to have a book of business with a loss ratio in excess of 125% absent shortcomings on the part of the agency or its company. To allow a company with a great number of these policies to be able to cede such policies at a reduced cost would further erode any incentive for that company to carefully manage this book of business. Allowing this almost "free" cede would likely cause a company to want to spend even less capital and attention on managing that book of business and reducing potential fraud as the losses generated by that business would now be even more greatly diffused through the pool. In fact, by allowing the HLR ERP business to count towards the ERP quota for subscription purposes, the proposed K-factor change dilutes that company's share of the residual market losses even further.

Another byproduct of CAR's proposed Rule 11 is the negative impact it may have on certain producers. We find it to be likely that a K-factor of one for HLR ERP business will cause carriers to shift their unprofitable business towards the HLR ERPs to take advantage of the lower K-factor. For example, a company could direct all of its high risk business to its HLR ERPs to take advantage of the lower K-factor. This would move that business from a non-HLR ERP, costing the non-HLR ERP the commission dollars generated by that business. Indeed this proposed rule could potentially treat voluntary agents far differently from HLR ERPs, at a real cost of commission dollars. Such a result also is unacceptable.

On the record of this hearing, we would have approved a K-factor of four for all ceded exposures, with the exception of motorcycle and miscellaneous classes and inexperienced operator and SDIP class exclusions had it been recommended.

PART II: RULE 12

CAR's Rule 12 Proposal

CAR's Rule 12 seeks to avert disproportionate representation of particular classes or territories in the residual market plan by providing an incentive -- financial rewards, or "credits" -- to motivate carriers to retain exposures associated with statistical or driver classifications and/or territories that they otherwise might cede to the residual market.[36] These credits benefit a carrier by reducing the size of its share of the residual market deficit. Rule 12 assigns residual market participation credits to CAR members based on retained business in certain territories (Rule 12, A, Territorial Credits[37]), and in certain driver and statistical classes (Rule 12, B, Classification Credits[38]) that otherwise would be disproportionately represented in the residual market. Rule 12 uses the subsidies in the rates and the predicted CAR deficit to determine the application of credits on territory and class bases. The current Rule 12 participation credits are additive; a carrier for a single exposure may receive both a credit based on the territory of the exposure and also a credit based on the driver or statistical class of the exposure.

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[36] Section 113H (C) (para. 8) of chapter 175 of the General Laws provides as follows with respect to the residual market plan that provides motor vehicle insurance to consumer applicants who have been unable to obtain insurance through the method by which insurance is voluntarily made available:

> To control the size of the population of the plan, the plan shall annually provide for territorial and classification credits for those companies voluntarily writing private passenger automobile insurance within those territories and classifications that would otherwise be disproportionately represented in the plan. The size of the credits shall be such as to enhance the prospects that no classification or territory is disproportionately represented in the plan.

Section 113H (E) (para. 7) of chapter 175 of the General Laws authorizes incentives, as well as penalties, to prevent abuse of the residual market plan.

The statutory language of G.L. c 175, §113H (C) (para. 8) is reiterated in Article VI (Credit Provisions) of CAR's Plan of Operation:

> To control the size of the population of the Plan, the Rules established in accordance with Article X annually provide for territorial and classification credits for those companies voluntarily writing private passenger automobile Insurance within those territories and classifications that would otherwise be disproportionately represented in the Plan. The size of the credits shall be such as to enhance the prospects that no classification or territory is disproportionately represented in the Plan. The allowance of such credits shall be based upon each Member's statewide mix of business in such a manner that any Member Company accepting its fair share of business in all classes and territories shall not be penalized. No Member Company may receive credit for any risk insured through CAR.

[37] For example, credits are given for retained business written in the higher-rated territories.

[38] For example, credits are given for retained business written for inexperienced operators.

In *Bulletin No. 799, Proposed Changes to Rules of Operation*; CAR proposes two changes to the current Rule 12. CAR proposes to consolidate the residual market participation credits available to CAR members into a single credit factor "matrix." CAR also proposes a $115 value of a credit.

CAR asserts that its Rule 12 proposal "represents a significant change in methodology and results over prior years" and that the proposed "matrix approach" will "more effectively target credits toward under-priced and therefore more likely to be ceded risks," eliminating credit redundancies and more effectively targeting the appropriate risks.[39] A comparison of the proposed credit matrix to the methodology of previous years, CAR asserts, leads to the following conclusions: (1) while there are 2.5% fewer credits available overall, credits for the most under priced territories would increase almost 30% (see Exhibit B of document #16); (2) available credits for HLR ERPs would increase 36%, thereby providing significant incentive to retain business in light of the proposed reduction in the K-factor set by CAR's proposed Rule 11 changes (see Exhibit C of document #16) and (3) as a result of the new distribution of credits, the significant discrepancies between the market shares and deficit shares of several carriers are narrowed, but not eliminated, thereby continuing to provide appropriate incentive to retain difficult risks. CAR argues that the proposed credit matrix approach will provide a strong incentive to control the cession rate, "offsetting any speculation that the lowered K factor [in proposed Rule 11] would increase the size of the residual market." In additional testimony,[40] CAR asserted that it does not anticipate an increase in the size of the residual market if the proposed changes to Rules 11 and 12 are approved because of the significant increase in credits applicable to HLR ERP exposures.

Finally, CAR argues that the credit values for the proposed Rule 12 need not be reevaluated in light of recent reductions in the policy year 2003 and 2004 deficit projections. Although the policy year 2003 deficit projection underlying the initial 2005 credit indication was $303,000,000, CAR selected a value of a credit resulting in an

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[39] See the testimony of Michael J. Trovato, Executive Vice President and treasurer of CAR, document #16 in the record.

[40] See document #45 in the record.

implied expected 2004 deficit of $260,000,000. These results, CAR asserted, are in line with recent deficit projections and indicate that the credit values need not be reevaluated.

Support for CAR's Rule 12 Proposal

Arbella[41] testified that it "enthusiastically supports" the proposed change to Rule 12, the significance of which "should not be underestimated." Establishing a credit matrix, Arbella believes, "represents a major step towards meaningful reform and a more equitable allocation of the [CAR residual market] deficit."

Hanover[42] argued that the proposed changes to Rules 11 and 12 are routine in nature, representing routine annual updates of the "K-factor" and the "credit offer" that are set annually, as is mandated by G. L. c. 175 § 113H, to address the formula for determining utilization ratios. The proposed changes, Hanover asserted, are intended to control the size of the population of CAR and to partially address the inequitable distribution of the HLR ERP business among the carriers.

Premier[43] stated that the proposed changes to the Rules "represent a sound approach to encouraging rational behavior in the market place and a fairer distribution of the residual market burden than the Rules that governed the 2004 market and earlier." Premier asserted that the proposed Rules are "rational and related to their purpose of encouraging carriers to write business in territories that would otherwise be over represented in the residual market." Premier agreed with Hanover that the proposed changes to Rules 11 and 12 -- setting the K-factor and establishing a credit system -- are routine matters that are at the core of the business of CAR, and which appear extraordinary on this occasion only because of the larger context in which they have been proposed.

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[41] See the testimony John F. Donohue, Chairman and Chief Executive Office of Arbella Insurance Group, document #18 in the record. Arbella opposed the proposed changes to Rule 11. Arbella's arguments that approving the proposed changes to Rule 11 would violate the stay imposed by the Superior Court in *The Commerce Insurance Company, et al. v. Commissioner of Insurance, et al.,* Suffolk Superior Court, C.A. No. 05-0032, are now moot, in light of the granting of summary judgment in that litigation in favor of the plaintiffs. See note 29, *supra*.

[42] See the testimony of William J. Cahill, Jr., Vice President and Group Counsel for The Hanover Insurance Company, document #25 in the record.

[43] See the testimony of Richard Welch, President and Chief Executive Office of The Premier Insurance Company of Massachusetts and Chair of the Actuarial Committee of CAR, document #26 in the record.

Safety[44] strongly urged that the proposed changes to Rules 11 and 12 be approved. In support of the proposed changes, Safety quoted the following from the Commissioner's findings in her *Order on Proposed Changes to the Commonwealth Automobile Reinsurers' Rules of Operation, Docket No. C2004-02*:

> Analysis prepared by the State Rating Bureau ("SRB") concluded that, while the current credit valuation methodology is theoretically sound, the method used to derive the number of credits for driver classes and territories is significantly flawed because it allows companies to receive credit for retaining "subsidy paying" risks, and fails to provide enough credit for risks retained which receive very large rate subsidies. Credit values were particularly weak for inexperienced operators in urban areas, and, as a result, a disproportionate number of them are currently insured through the residual market pool. The SRB analysis also concluded that the current method of valuing credits artificially inflated the number of credits in the system, and resulted in extremely high leverage to some company participation ratios.

Safety stated that the current system of "making up" a value of a credit, using parameters that give excess credits in overpriced territories and classes, and deficient credits in under priced territories was clearly wrong. Furthermore, Safety asserted that the current Rule 12 credits also were hurtful to companies that were oversubscribed with HLR ERPs, forcing companies to incur a disproportionate share of the burden of the residual market.

Calling the proposed changes the "most significant improvement to the credit methodology . . . seen over the past 20 years,"[45] Safety argued that the subsidy in the rates will drive the credit if the proposed change is approved, thus eliminating what it termed three irrational flaws in the current Rule 12 credit methodology:

> 1. A territory credit plus a class credit is inaccurate. The redundancies/subsidies are the result of loss experience, which does not have a linear relationship by territory and class. There is no reason for an additive credit system. The matrix approach is much more accurate. Credits line up with the actual subsidies in the rates, with overpriced risks receiving a credit of zero.
> 2. The removal of the capping give[s] the appropriate credit to under priced risks.[46]

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[44] See the testimony of Edward N. Patrick, Jr., Vice President Underwriting of Safety Insurance Group, Inc., document #23 in the record.
[45] See the testimony of Glenn R. Hiltpold, FCAS, document #37 in the record.
[46] Current Rule 12 gives no more than a credit of 9.0 for any class.

3. The effect of parameters was to create artificial credits for overpriced risks. Overpriced risks received too many credits, while the under priced risks always received too few. The removal of parameters will put credits where they belong.

Safety argued that the proposed Rule 12 credit offer will lead to a more rational marketplace, because the cession decision made on each policy will become rational: "proposed Rule 12 moves away from a world of irrational credits into a world where the credit is tied to each risk." Because the proposed methodology ties the credit in a matrix cell to the rate subsidy for that cell, Safety argued that every carrier under the proposed Rule 12 will receive the correct economic compensation for voluntarily writing an under priced piece of business. Currently, Safety asserted, under priced risks are ceded at above average cession rates because a rational carrier knows that it will not receive the proper compensation if it were voluntarily to write these risks: "Carriers are currently under-compensated for writing under priced risks." On the other hand, Safety argued that carriers who operate in overpriced territories are over compensated. The retaining of an overpriced piece of business with a credit attached, according to Safety, has a two-fold benefit: (1) a below average loss ratio due to the redundancy in the rate and (2) a reduced share of the CAR deficit for retaining the credit. Since the CAR deficit is a zero-sum game, Safety asserted that those companies that benefit from an artificially reduced participation factor[47] are artificially increasing the participation factor of companies that write the business in under priced areas where credits are capped. Furthermore, Safety asserts that gaming takes place in the credit-inflated areas to the detriment of those carriers with an unfair burden of HLR ERPs. Thus, Safety concludes, the proposed changes to Rule 12 will mean that carriers (1) are not over-compensated for retaining overpriced risks and (2) are properly compensated for writing under priced business.

OneBeacon[48] argued that proposed Rule 12 will increase the amount of credits available in Territories 15 to 26 by almost 31%. OneBeacon asserts that there will be strong incentives for carriers to reduce cession rates in these areas due to this substantial increase in credits.

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[47] Each carrier's participation ration is calculated by the application of Rules 11 and 12.
[48] See the testimony of Robert Cordner of OneBeacon Insurance Company, document #34 in the record.

USAA[49] stated that CAR's proposed new credit offer system, which attempts to match the residual market credits to the rates and subsidies, will encourage a carrier to retain business that under the present Rule 12 might not be viewed as desirable or profitable. This, USAA, argues, is consistent with current law requiring creation of a credit system.

Support for the proposed changes to Rule 12 also was expressed by Plymouth Rock,[50] Encompass Insurance Company,[51] Amica,[52] Liberty Mutual[53] and The Massachusetts Insurance Federation for The Coalition for Auto Insurance Reform.[54]

Opposition to CAR's Rule 12 Proposal

Commerce[55] recommended that the Commissioner should not approve the proposed changes to Rules 11 and 12, but instead should "promulgate Rules 11 and 12 as they existed in 2004, with appropriate updates to the credit offer to comply with the statutory mandate." Commerce stated that proposed Rule 12 deserves additional analysis and enhancement, to assure that it meets its statutory goals, in several particulars.

Commerce argued that the proposed Rule 12 represents a significant methodology change as respects the setting of CAR participation credits. Specifically, Commerce noted that the proposed Rule 12 is the first time that CAR has developed credits based upon the so-called "credit matrix" methodology. While acknowledging that the approach is "appealing theoretically," Commerce complained that "it dramatically decreases the

[49] See the testimony of Michael J. Broll, Assistant Vice President - Property and Casualty Insurance, and John P. Friedman, Assistant Vice President and Senior Legislative Counsel - Northeast Government Relations, documents 29 and 41 in the record.

[50] See the testimony of Hal Belodoff, President of Plymouth Rock Assurance Corporation, document #21 in the record.

[51] See the testimony of Andrew J. Carpentier, Chief Operating Officer for Encompass Insurance Company, document #22 in the record.

[52] See the testimony of Robert P. Suglia, Senior Vice President and Assistant General Counsel for Amica Mutual Insurance Company, document #24 in the record.

[53] See the testimony of Donald Baldini, Assistant Vice President and Senior Legislative Counsel for Liberty Mutual Group, document #27 in the record.

[54] See the testimony of James T. Harrington, Executive Director of The Massachusetts Insurance Federation, for The Coalition for Auto Insurance Reform, document #28 in the record

[55] See the testimony of James A. Ermilio, Senior Vice President and General Counsel of The Commerce Insurance Company, document #19 in the record, and the testimony of David H. Cochrane, Senior Vice President - Underwriting of The Commerce Insurance Company, document #20 in the record. Commerce's arguments that approving the proposed changes to Rules 11 and 12 would violate the stay imposed by the Superior Court in *The Commerce Insurance Company, et al. v. Commissioner of Insurance, et al.,* Suffolk Superior Court, C.A. No. 05-0032, are now moot. See note 29, *supra*.

overall number of available credits (when the value of a credit is held constant), such that the introduction of such a change deserves careful consideration."[56] Commerce argued that implementation of the credit matrix will decrease significantly the financial incentives available to carriers for writing credit-eligible business, from approximately $541,700,000 in 2004 to approximately $328,200,000 in 2005; a decrease of $213,500,000 (39%).

Commerce argued that the economic value of the credits available under proposed Rule 12 (after adjusting for the difference in the Actuarial Committee's estimated value of a credit between 2004 and 2005) will be decreased in most urban territories. This will generally occur, it argued, as a result of increasing the credit incentives available for certain youthful exposures in those territories, while significantly decreasing or removing the credit incentives from the other classes. The reduction in credit eligible exposures can only result, Commerce claimed, in additional cessions in these territories, some of which already are heavily ceded (*i.e.*, as compared to 6.9% ceded for the total market in 2003, territory 13 was 11.7% ceded and territory 14 was 14.2% ceded). Commerce argued that many of the individual classes that will experience decreased or eliminated credits already have above-average cession rates.

Commerce criticized CAR for not performing an analysis or "tempering" of the changes in the proposed Rule 12, which it claimed would have introduced real world results, reflecting the "behavioral" aspects of cession decisions, to the actuarial credit indications derived from analysis of rate subsidies. The current use of "parameters," Commerce asserted, assured that the credit offer for a heavily ceded class was not reduced, even when the actuarial credit indications called for a decrease, since that direction would be inconsistent with the goal of having no class or territory disproportionately represented in CAR.

Commerce also criticized CAR for its choice of methodology for calculating the rate subsidies in the proposed Rule 12. The Automobile Insurers Bureau of Massachusetts ("the AIB") had recommended two methodologies for CAR's review. Rather than using

[56] Ironically, Commerce advocated a credit matrix mechanism in testimony in a previous docket on October 29, 2004. See document #23, testimony of Edward N. Patrick, Jr., Vice President Underwriting of Safety Insurance Group, Inc., attached to which is a copy of the testimony of Arthur J. Remillard, Jr., Chief Executive Office of The Commerce Insurance Company in Docket No. C2004-02, *Proposed Changes to the Commonwealth Automobile Reinsurers' Rules of Operation.*

the methodology that incorporated credibility, CAR's proposed Rule 12 uses the other method identified by the AIB. The different methods, Commerce asserted, can result in significant differences in the indicated credits for specific cells as well as overall.

Finally, Commerce stated that its analysis demonstrates that the proposed Rule 12 contains an overstated value of a credit. Commerce asserted that a $115 value of a credit is too high because (1) the marginal value of a credit decreases significantly as the size of a company increases and (2) the proposed Rule 12 uses the "outdated, inflated estimate of the 2003 CAR deficit, rather than employing the most current and accurate data, which indicate a much lower estimated deficit," which would generate significantly more credits.

In its subsequent filing,[57] Commerce recommended establishing a mechanism to assure that the Rule 12 Credit Offer is reflective of both known rate subsidies and actual industry cession behavior. Arguing that the Rule 12 Credit Offer is designed to make carriers indifferent to writing rate subsidized business voluntarily, by providing credits based upon the dollar subsidies established by the Commissioner for the particular class/territory cell, Commerce asserted that the trend of urban and youthful exposures, despite credits, to be disproportionately ceded to CAR "is expected to continue despite the implementation of the credit matrix approach." Accordingly, Commerce argued that CAR should develop a mechanism to assure that the credit offer considers actual industry cession behavior, so that urban and youthful exposures are not disproportionately ceded to CAR.

Blank's Position on CAR's Rule 12 Proposal

Blank's position[58] regarding CAR's proposed changes to Rule 12 does not neatly fit within the heading of "proponent" or "opponent;" therefore Blank's discussion is reviewed separately.

Blank criticized the historical "additive approach" that CAR has used since 1994, in which CAR has estimated separately average rate subsidies for each territory and for each driver/statistical class. The most problematic feature of this additive approach, Blank argued, is that it does not reflect the way in which the Commissioner establishes rates by driver class and territory. Blank asserted that rates for any given driver class and

[57] See document #42 in the record.
[58] See documents #46 and #47 in the record.

territory combination are calculated using the experience of that combination; not on the basis of rates calculated using the statewide loss experience for each driver class and each territory independently. This comports, Blank claimed, with the subsidies calculated in the annual report prepared by the AIB, which also are calculated for each driver class and territory combination. CAR then averages these figures from the AIB, Blank asserted, to create a summary subsidy estimate for each driver class and territory separately. Asserting that CAR assigns credits only when the average rate subsidy is negative, Blank argued that the additive approach produces credits for drivers whose rates actually reflect positive rate subsidies, *i.e*, who are drivers who are charged a rate that is too high relative to expected costs for such a driver. As support for this argument, Blank noted that the 2004 credits, figured on the basis of the additive approach, made credits available to insurers for 27% of all insured exposures, whereas the 2004 Tillinghast Report[59] indicates that only 14% of all insured exposures had a negative rate subsidy, which Blank argued should be the potential basis for generating a credit to an insurer.

Blank endorsed the matrix approach as an improvement to the historical additive approach because, she asserted, the matrix approach eliminates credit redundancies and more effectively targets the appropriate exposures for credits. She appeared to agree with CAR that (1) while the "number of available credits" under the matrix approach is 2.5% less than the credits available under the additive approach, the matrix approach produces 30% more credits in the most under priced (subsidized) areas and (2) the significant discrepancies between several carriers' market shares and their shares of the residual market deficit are narrowed, but not eliminated, thus continuing to provide appropriate incentive to retain difficult risks. Noting that these are desirable outcomes for any credit system, Blank nevertheless asserted that the parameters used to generate the proposed Rule 12 retention credits for each driver/statistical class and territory combination do not lend themselves to a transparent or readily understood process. Blank stated that the changes to Rule 12 as proposed by CAR are problematic in the following particulars: its deficit share formula, its value of a credit of $115 and its matrix calculations.

[59] Blank filed a copy of an April 2004 report prepared by the Tillinghast business of Towers Perrin titled "Analysis of Commonwealth Automobile Reinsurers" (the "Tillinghast Report") in the record of this proceeding (see document #47 in the record).

Blank argued that CAR's continued use of the same deficit share that has been used since 1994 will perpetuate the gaming and misinformation surrounding the calculation of credits and likely will not result in a process or outcome that generally is perceived as fairer than the current system. Based on modeling done assuming the same value of a credit, Blank reported that the participation ratios under a matrix approach track more closely with the pre-credit utilization ratios[60] than they do under the historical additive approach. However, while admitting that this may have intuitive appeal, Blank asserted that it is not immediately clear if, or why, this result is fairer.

Blank stated that, since 1996, CAR's estimated average value of a credit for the purpose of determining the number of credits consistently has fallen short of the value that a credit should have had, once the actual deficit became known. She asserted that, based on the traditional calculation of the value of a credit, CAR's proposed $115 value is understated. A value of a credit of between $140 and $163 would be more in line with historical actions by CAR, Blank stated. The result, she argued, is that the value of a credit of $115 will lead to an overstatement of the "number of available credits," which will, in tandem with an industry dynamic to make increasing use of them, serve only to increase the leveraged effect of the difference between a company's pre-credit utilization ratio, which adjusts a company's retained exposures for the proportion by which the company cedes more or less business to CAR (which Blank refers to as "PCUR") and its market share of all credits used (which Blank refers to as "CCMS"). Blank stated that it is unclear why an increased leverage on the difference between a company's PCUR and CCMS is appropriate or fair. The impact of this leverage factor as an adjustment to deficit participation ratio is far more significant than the pre-credit utilization ratio, and its meaning far more opaque, she stated. Use of credits, Blank concluded, clearly has an unequal effect on the final deficit participation ratios of companies for reasons that remain unclear.

Blank asserted that the AIB was asked by CAR to produce a comprehensive "matrix" of the subsidies for all measurable sources of subsidy specifically for the purpose

[60] An insurance company's pre-credit utilization ratio adjusts a company's retained exposures for the proportion by which the company cedes more or less business to CAR. This adjustment is made prior to the application of Rule 12 credits.

of calculating the number of Rule 12 credits. In response, the AIB produced two new calculations, which Blank referred to as "Approach 1" and "Approach 2," in her testimony.[61] Both approaches, Blank asserted, are based on three years of actual loss experience.[62] Blank described both matrix approaches as attempting to more rigorously determine what the actual cost-based rate would have been had statistical class been used to determine rates, in each case the estimate of the actual cost-based statistical rates then being compared with the Commissioner's approved rate for the driver class and territory combination to determine the level of subsidy in that rate. The primary difference between the two matrix approaches, she argued, is the means by which "credibility" is imputed to the rate. Blank defined "Credibility" as follows:

> "Credibility is essentially a value between 0 and 1 the [*sic*.] represents the reliability of the data point in representing expected losses. To the extent the credibility measure is less than 1.0, the analyst may wish to rely on alternate statistics. Credibility can and does alter the pure premium relativities underlying the Commissioner's rate, and would equally alter those relativities in the absence of subsidy. The pure premium adjustments that arise from credibility are not considered "subsidy," -- they are adjustments that limit the extent to which certain statistics are influenced by random data fluctuations.

Blank stated that credibility adjustments are common in all ratemaking techniques.

Blank stated that Approach 2, the matrix approach adopted by CAR, is somewhat less rigorous than is Approach 1 in its credibility adjustments. Blank described the two matrix approaches as follows:

> Approach 1, [sic.] attempts to measure what the actual cost-based rate would have been at the level of statistical class by first calculating the three year average loss pure premium relativity for the statistical classes within each driver class. This pure premium is then compared to the loss pure premium underlying the Commissioner's approved rate. This has the advantage of tying the statistical class pure premiums directly to the credibility adjusted loss pure premiums for the driver class as a whole. These loss pure premiums are then loaded for profits and expenses consistent with the Commissioner's decision, the result of which is an estimate of the actual cost-based rate for each statistical class. These statistical rates balance to the overall approved rate for the rate class. These rates are then compared to the Commissioner's approved rate for the

[61] See Exhibit 7 to document #46 in the record.
[62] See Exhibit 10 to document #46 in the record, pages 4-8.

> purposes of measuring subsidy within each one, thereby ensuring that the total subsidy within the new matrix balances to zero.
>
> Approach 2 is somewhat less rigorous. Approach 2 calculates the three year loss pure premiums for each statistical class within a rate class and then loads them directly for profits and expenses consistent with the Commissioner's decision. The average rate derived from the new "statistical class rates" generally does not balance to the actual cost-based rate underlying the Commissioner's approved rate because the loss pure premiums underlying them have not been adjusted for credibility. To adjust for this, the statistical rates are adjusted by the difference between the average rate they generate and the average rate approved so that balance is achieved. While the average approved rate is balanced in this approach, it is not necessarily true that the average subsidy will still balance to zero because loss credibility is not specifically adjusted for.

Blank noted that the AIB actuary indicated that she would lean towards a recommendation for Approach 1 because this method ensured that detailed cost-based rates by statistical class and territory would reconcile to the statewide average in accordance with the annual subsidies analysis.

Blank asserted that the matrix subsidy calculation adopted by CAR's actuarial committee was based on a misunderstanding of the differences between the two calculations that simultaneously were submitted to the CAR actuarial committee by the AIB on April 22, 2004.[63] Of the two matrix calculations of subsidies by driver/statistical class and territory combinations that were submitted by the AIB, she asserted that CAR has based its proposed changes to Rule 12 on Approach 2, the one that was less accurate and less consistent with the Commissioner's ratemaking methodology.

In conclusion, Blank identified what she views as five primary deficiencies in the changes to Rule 12 that are proposed by CAR. She stated that the method for estimating the number of credits is more complicated than necessary, is subject to large forecast errors and is managed by a committee process that is fraught with inherent conflicts of interest. Second, she asserted that the method for establishing the number of credits does not respond timely to changes in relative rate adequacy, CAR deficit levels or other

[63] Blank asserts in its Exhibit 7 that the CAR actuarial committee favored Approach 2 "because it was based on actual loss experience," but that both of the matrix approaches in fact were based on three years of actual loss experience.

market dynamics. Third, Blank argued that (1) the formula by which the credits are applied to a company's participation ratio is highly leveraged with no clear or meaningful foundation for this effect and (2) the effect of credit usage on any single company's deficit share can be significantly impacted by changes driven by the industry as a whole, making it difficult for them to plan operations. Fourth, she asserted that the current formula for calculating the deficit participation ratio does not adequately reflect the extent to which different companies voluntarily retain business that has a negative rate subsidy, *i.e.*, business from drivers who are charged a rate that is too low relative to expected costs for such a driver. Finally, Blank stated that the proposed changes are not likely to result in meaningful changes in the allocation of the CAR deficit in the long-run.[64]

However, despite these reservations about the Rule 12 changes proposed by CAR, Blank concluded that the proposed use of a credit matrix for establishing retention credits is a very positive move and should facilitate more equal representation within the pool by driving skill and garaging location. Blank therefore recommended that the Commissioner adopt the AIB's subsidy matrix calculation referred to as Approach 1 (the alternate matrix calculations by the AIB, which were *not* adopted by CAR for its Rule 12 proposal) as the basis for measuring and allocating subsidies relative to the allocation of premiums, losses and expenses at CAR.

Discussion and Analysis of CAR's Rule 12 Proposal

The language that often is used in discussing Rule 12 matters can be unnecessarily confusing or obscure. For example, an actuary[65] may define exposures that are charged

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[64] Blank's discussion of the proposed changes to Rule 11 contained the following statements (page 5 of document #46):

> 3. The proposed changes to Rule 12 which increase the value of retention credits *to proper levels* for drivers with limited driving experience and/or residing inurban [*sic*.] areas will not likely reduce the disproportionate number of these drivers in the pool. If anything, the disproportionate representation of these drivers in the pool can be expected to increase.

We understand this discussion *not* to be a rejection of the proposed Rule 12 changes themselves, but as stating the opinion that the proposed changes to Rule 12 will not counteract the asserted effect of the proposed changes to Rule 11, which Blank asserts will have the effect of increasing the size of the residual pool. This way of understanding the discussion quoted above from Blank's point 3 about Rule 11 is supported by the fact that the discussion of point 3 continues with a discussion of how the interaction of the proposed K factor of 1 for cedes from HLR ERPs in the proposed changes to Rule 11 will increase the number of exposures ceded to CAR. We have rejected the proposed changes to Rule 11 earlier in this Decision.

[65] See document #46 in the record.

rates that are too low relative to expected costs for such risks as having a built-in "negative rate subsidy" in the amount by which the rate charged is too low relative to expected costs. Although such exposures properly may be described by an actuary as having a "negative" rate subsidy,[66] we believe that a definition that will be more readily comprehended by non-actuaries is that these exposures, which are *receiving* a subsidy (a subsidy from those exposures that are overpriced), are "subsidy-receiving exposures." Similarly, an actuary properly may define exposures that are charged a rate that is too high relative to expected costs as having a "positive rate subsidy" in the amount by which the rate charged is too high relative to expected costs. We believe a more readily comprehended way of describing these exposures is "subsidy-providing exposures." These overpriced exposures ("positive rate subsidy" exposures) provide the subsidies that are received by the under priced exposures ("negative rate subsidy" exposures), yielding a zero-sum result with regard to the total market for private passenger automobile liability insurance.

Since 1994, CAR annually has established credits, incorporated into Rule 12 of the CAR Rules of Operation, for insurance companies that do not cede to CAR, but instead voluntarily write exposures with rates that are too low relative to expected costs, *i.e.*, subsidy-receiving exposures; those that have a built-in negative rate subsidy. The identification of rate subsidies by CAR is based on an annual report from the AIB that attempts to measure the subsidies in the rates established by the Commissioner. In the past, CAR separately has estimated (1) average rate subsidies for each territory and (2) average rate subsidies for each driver/statistical class. Thus, for purposes of applying the Rule 12 credit provisions, an exposure historically has been evaluated independently relative to two characteristics: (1) the characteristics of the driver and (2) the location at which the vehicle is garaged ("territory"). The credit approach thus historically has been "additive:" an exposure can be assigned a credit based on driver class and an additional credit based on territory, the exposure's total credit being the sum of the two credits.

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[66] Similar to how a credit in accounting practices typically is rendered as a negative number, typically in parentheses. Thus, a "negative rate subsidy" means that the exposure in not providing any subsidy, but rather is receiving a subsidy.

Since the purpose of Rule 12 is to reward a carrier for retaining the risk of an exposure for which it receives insufficient premium relative to the risk being undertaken (*i.e.*, that is a subsidy-receiving exposure), it makes sense for the benefit that is received by the carrier as a reward (*i.e.*, the Rule 12 credit) be commensurate with the amount by which the retained risk is under priced (*i.e.*, the amount of subsidy that it receives).

Determination of the number of credits that will be available under Rule 12,[67] whether the historical additive approach or a matrix approach is used, relies upon an estimate of the "value of a credit," which can be defined as follows:

$$\frac{\text{(Estimated deficit for a policy year)}}{\text{(Industry-wide exposures retained voluntarily) - (Industry-wide credits)}}$$

In a matrix approach, the number of credits available for each driver/statistical class and territory combination is calculated as follows:

$$\frac{\text{(Average negative rate subsidy for driver/statistical class \& territory combination)}}{\text{(The value of a credit)}}$$

Thus, the value of a credit and the number of credits vary inversely; the larger the value of a credit, the fewer in number are the total number of credits that are available, and vice versa.

We begin our discussion and analysis of the proposed changes to Rule 12 by reiterating portions of the discussion of the current Rule 12 in our *Decision on Proposed Changes to the Commonwealth Automobile Reinsurers' Rules of Operation, Docket No. C2004-02,* filed August 27, 2004 (the footnote has been renumbered):

> There can be little doubt that the current credit system is not only flawed, but that it has significantly contributed to many of the most serious problems in the Massachusetts private passenger automobile insurance marketplace. The single most problematic result of this system is the disproportionately high representation of urban and inexperienced operators in the pool.[68] The current credit system is also a primary factor in the inequitable distribution of the financial burden of the residual

[67] See, *e.g.*, the testimony of David H. Cochrane, Senior Vice President - Underwriting of The Commerce Insurance Company, document #20 in the record and the testimony of Cara M. Blank, document #46 in the record.

[68] The current credit mechanism does not keep urban drivers who have no accidents or violations from being disproportionately represented in the residual market pool. This appears to be a direct function of a longstanding practice by CAR of measuring credits by driver class and rating territory independently rather than conjunctively. Further, the current methodology has also highly leveraged some companies' final participation ratios due to the excessive number of credits in the system.

> market. It is imperative that that credit system be replaced with one that fairly and equitably distributes the burden of the residual market and, in so doing, improves the overall market for both consumers and the industry. . . .
>
> . . .
>
> . . . Subsidies are introduced in the rates on a revenue-neutral basis statewide so that positive and negative subsidies balance, and no additional revenue, or deficit, is created. . . . The ratemaking methodology for introducing rate subsidies through off-balance factors means that the system balances to zero for all business, without regard to the status of the producer or whether the business is written through CAR.
>
> Under the current system, once a decision to cede is made, the premium on that risk is transferred from the company to CAR. On average, the net subsidy associated with ceded premium is negative, while the net subsidy associated with retained premium is positive. A company with a positive net retained subsidy will "clear" that subsidy when it receives its deficit allocation for the policy year. This system does not ensure that a company's "net overall subsidy" is zero. . . .

While the testimony in this docket occasionally has been wide-ranging, we have limited our discussion and analysis to the two matters that CAR has proposed to change in Rule 12 in its *Bulletin No. 799, Proposed Changes to Rules of Operation*: (1) consolidating the residual market participation credits to CAR members based on retained business in certain territories and in certain rate and statistical (driver) classes that otherwise would be disproportionately represented in CAR into a single credit factor "matrix" and (2) adopting Rule 12 credit matrix indications based on a $115 value of a credit. We find that the two specific changes to Rule 12 that are being proposed by CAR constitute the proper scope for this proceeding and believe that it would not be advisable to consider the implications of further-ranging testimony because (1) no change to the traditional approach to the valuing of a credit is being proposed by CAR and (2) not everyone who has been involved in this proceeding has addressed the additional matters that have been discussed by some and we therefore have not been provided with the insights and arguments of others on these additional matters. Nevertheless, although this Decision will not, therefore, undertake to determine these additional issues raised, *inter alia*, by Commerce, Safety and Blank,[69] we are ordering CAR to study the comments and

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[69] We especially were interested in these comments by Blank (pages 18-19):

recommendations made in this proceeding about participation ratios and the traditional approach to the valuing of a credit as part of considering further changes to Rule 12 concerning these matters.

We are persuaded that a Rule 12 matrix methodology will avoid the unwarranted and undesirable result of giving credits for voluntarily writing exposures involving driver classes that were not under priced due to subsidy, which did result when the flawed additive approach for credits was used. However, since the statistical rates set by the Commissioner are adjusted by the difference between the average rate they generate and the average rate approved so that balance is achieved, it is essential that the credits in the matrix also are adjusted for credibility. Credibility adjustments are common in all ratemaking techniques. We cannot endorse, therefore, the credit matrix that is proposed by CAR. Without loss credibility adjustments, the average subsidy may not balance to zero. As noted in the record, the AIB actuary indicated that a matrix methodology incorporating credibility will ensure that detailed cost-based rates by statistical class and territory will reconcile to the statewide average in accordance with the annual subsidies analysis. Thus, CAR's proposed changes to Rule 12 are based on a credit matrix that is not as accurate and consistent with the Commissioner's ratemaking methodology as an alternative matrix crafted by the AIB.

Although we have rejected the credit matrix proposed by CAR, on the record of this hearing the other credit matrix crafted by the AIB, which CAR rejected (called Approach 1 by Blank), would have been approved if it had been recommended.

> Fair play and policy dictate that companies should not be able to earn profits simply by focusing their marketing efforts on geographical areas and driver classes that are overpriced by virtue of the Commissioner's rate subsidies. Since subsidies are introduced in the Commissioner's annual rate on a revenue neutral basis, to the extent the industry as a whole cedes premiums that include an aggregate negative rate subsidy to CAR, the deficit reported by CAR is partially comprised of an aggregate negative rate subsidy equal to the aggregate positive rate subsidy that is retained by the industry. The distribution of net positive subsidy retained will vary considerably by company. The financial burden of the deficit that results from rate subsidies should be shouldered in proportion to the extent each company has retained the mirroring positive rate subsidy. . . . The deficit net of this subsidy reflects the true rate inadequacy of the risks ceded to CAR, and can be fairly apportioned on the basis of pre-credit utilization ratios.

We believe that Safety makes the same point when it argues that carriers who operate in overpriced territories are over-compensated.

We are not persuaded that CAR's proposed value of a credit for purposes of calculating the number of Rule 12 credits is overstated, as Commerce argues. We note since 1998 annual credit values have always exceeded $130. See Exhibit 11 to document #46 in the record. On the record of this hearing, CAR has not persuaded us that a $115 value of a credit is appropriate; more explanation and proof for the chosen value of a credit is necessary. CAR offers no arguments in favor of this figure, and in light of the historical trends of the value of a credit, we are not prepared on the record of this hearing to approve such a low value; the record does not persuade us that a $115 value is not substantially understated. While an increase in the value of a credit necessarily will decrease the credits that are available, since the number of credits and the value of a credit are inversely proportional, we note that an understated value of a credit has the effect of diluting the impact of the credits that Rule 12 is meant to provide. Fewer, more valuable credits will provide the encouragement that Rule 12 should deliver for carriers to retain under priced (subsidized) exposures.

PART III: ORDER

CAR's proposed Rule 11 is approved only in part. The provisions establishing a 0.33 K factor for motorcycle and miscellaneous classes and inexperienced operator and SDIP class exclusions are hereby approved. The adoption of a distinct class of producers known as HLR ERPs, and a reduced K-factor of one for that business, is disapproved. We can see no equitable outcome to establishing a separate K-factor for this business for the reasons stated above, and direct CAR to reconsider this issue and establish a single K-factor for all ceded business, with the exception of motorcycle and miscellaneous classes and inexperienced operator and SDIP class exclusions.

The proposed changes to Rule 12 that have been submitted by CAR are hereby disapproved.

In addition to submitting a new proposal for Rule 12, CAR is ordered to study the comments and recommendations made in this proceeding about participation ratios and the traditional approach to the valuing of a credit, and to solicit additional comments on these matters, and to consider further changes to Rule 12, if not as part of a new proposal at this time, then in the near future.

Dated: September 20, 2005.

Julianne M. Bowler Commissioner of Insurance	Stephen M. Sumner, Esq. Presiding Officer	Mary Ellen Thompson, Esq. Presiding Officer