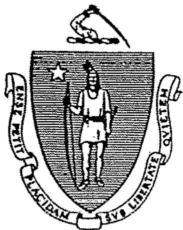
APPENDIX "B"



The Commonwealth of Massachusetts

Division of Insurance

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COMMISSIONER OF INSURANCE

Opinion and Findings On the Operation of Competition Among Motor Vehicle Insurers, Rendered June 1977

Setting and Background

On May 19, 1977, a hearing was commenced to consider the operation of competition among motor vehicle insurers in Massachusetts. The hearing was held under the authority of Chapter 175E of the Massachusetts General Laws, a new competitive rating statute in its first year of applicability. Prior to 1977, automobile insurance rates in the Commonwealth had been set by the Commissioner of Insurance. Every company made use of the Commissioner's uniform rate schedule unless it had filed for permission to use a lower rate. Requests by insurers to use lower rates, known as "deviations", were rare. Considerable public and legislative support for a system of competitive rates became apparent in 1976, and a bill containing the new Chapter 175E was signed into law on August 4, 1976.

Under the provisions of that chapter, each insurer may file its own schedule of automobile insurance

rates at any time, provided that the new rates can not take effect until at least forty-five days from the date of filing. During the forty-five day period or during an additional forty-five day suspension period available to the Division of Insurance, the Commissioner can disapprove the proposed rates on the basis of certain statutory standards. Companies can not use rates which have been disapproved by the Commissioner.

Apparently not comfortable with this single check on potential rating abuses by insurers long accustomed in Massachusetts to a non-competitive environment, the Legislature created an arsenal of additional safeguards in Chapter 175E. Section 6 of the chapter establishes stringent antitrust restrictions on the activities of insurers and rating organizations. Section 8 authorizes the Commissioner at any time to examine, suspend, and roll back rates currently in use by an insurer if he finds the rates to violate statutory standards or public policy. Section 9 allows the Commissioner to order the re-writing or cancellation of policies rated on the basis

of a filing made in "bad faith". Section 5 allows the Commissioner, on the basis of appropriate determinations concerning the operation of the competitive system, to temporarily suspend competition and return to the traditional system of state-made rates for all or any part of the automobile insurance market. The purpose of the hearing that began on May 19 was to evaluate the operation of competition as a first step toward possible action under Section 5.

Massachusetts car owners have long been vocal in their protests over high automobile insurance rates. Scarcely a year goes by when the press is not filled with stories of angry consumers reacting to rate increases. This year, however, was not an ordinary year.

In 1976, the statewide average rate increase was about 15%. In 1977, it was less than 12%. Rate increases, though, were not evenly distributed by territory. A central Boston driver, for example,

might have seen an increase many times the state-wide average. Rates for a standard coverage package as filed by the Aetna Casualty and Surety Company, the state's second largest automobile insurance writer, rose an average of 50% in central Boston, bringing the average premium there to about $1280.[1] Rates filed by the Kemper Insurance Company, the state's fifth largest writer and the major carrier with the lowest statewide increase, rose by 0.2% overall. Kemper rates for the

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1. For illustrative purposes in this decision, a standard package of coverages is designed to include bodily injury liability coverage with limits of $100,000/$300,000; uninsured and underinsured motorist coverages with limits of $5000/$10,000; collision and comprehensive coverages with $200 deductibles; $5000 medical payments coverage; and towing and labor and substitute transportation coverages. The vehicle used for the example is a 1975 model with a purchase price of approximately $4500. Actual rates vary widely by type of vehicle and many drivers, of course, omit some of the options in this illustrative package.

Central Boston driver rose by approximately 10% to a premium range of $950.

While a number of Massachusetts policyholders, principally adult drivers in sparsely populated areas, received substantial rate decreases in 1977, youthful drivers and urban drivers at many companies were billed for increases far greater than they had traditionally experienced in the past. A record number of policyholders complained to the Division in early 1977 about high rates. The Director of the Division's Consumer Service Section testified at the hearing that, during the first quarter of this year, incoming telephone calls rose from an average level of 300 per day to 600 per day. He estimated that some 60% of the normal load of calls concerned automobile insurance and that 80% of the 1977 load concerned automobile insurance. He described the tone of the calls as the angriest his staff had ever received.

Policyholders complained to the Division in the same manner that they found themselves unable

to shop around for the lowest price available. They cited unavailability of price information, by telephone and in personal visits; incorrect estimates offered them by agents; refusals by companies to accept their business at the filed company rates; and numerous other difficulties encountered in purchasing 1977 insurance. The combination of sudden rate hikes and a feeling of frustration in attempts to take advantage of competition created for some elements of the public a sentiment which can only be described as rage. This hearing was called by the Division to determine whether charges of competitive failure have been accurate and substantial enough to justify action suspending the competitive system.

The hearing was held in five sessions. Numerous persons participated by offering testimony and submitting questions for witnesses. Three representatives of the Division of Insurance, an actuary, an economist-statistician, and the Director of Consumer Services, offered presentations on the nature and

function of competition. They presented voluminous materials for the record, including the results of information requests recently made to all insurers. Both the Massachusetts Consumers' Council and the Attorney General offered testimony, including that of a prominent economist and the results of market surveys on the availability of rate information. Numerous individual consumers, as well as organized consumer groups, offered their views on the success of the competitive system, particularly at special evening sessions held in Boston and Springfield. Finally, many insurers were actively represented at the hearing and participated through the presentation of statements and witnesses, questioning of other witnesses, and submission of post-hearing briefs.

The hearing was conducted in a format consistent with its fact-finding nature. All interested parties were given full opportunity to make presentations to the Hearing Officers. To assure ample opportunity for every participant to challenge all materials

presented, each participant was allowed, without limit, to offer supplemental and rebuttal testimony. Participants were permitted to query witnesses through written questions supplemented by limited oral follow-up.

A final session of the hearing was convened a week after the initial sessions in order to permit all participants ample time to review the earlier testimony and prepare appropriate questions and responses. The Division presented no new testimony at the closing session, but it made its earlier witnesses available for questions from other parties. Both the Division's actuary and its economist-statistician were questioned by insurers at that time. Finally, all participants were allowed to submit post-hearing briefs five days after the close of the hearing. The Attorney General; Aetna Casualty and Surety Company; Allstate Insurance together with the Commercial Union Assurance Companies; the American Mutual Insurance Alliance; the Hartford Accident and Indemnity Company; and the Travelers Insurance Companies all submitted briefs.

Statutory Standards

No hearing has ever been held before under Section 5. No precedents exist and no standards have been developed by any court or administrative agency. The precise language of Section 5 is, therefore, our best guide to legislative intent. The section provides, in full:

> If the commissioner determines, after a hearing, at which representatives of consumers and other interested parties may participate, and on the basis of findings of fact and conclusions, that with respect to any territory or to any kind, subdivision or class of insurance, competition is either (i) insufficient to assure that rates will not be excessive, or (ii) so conducted as to be destructive of competition or detrimental to the solvency of insurers, he shall within ninety days or as soon thereafter as possible and without regard to calendar dates specified in section one hundred and thirteen B of chapter one hundred and seventy-five, fix and establish the rates for such insurance or territory pursuant to the provisions of section one hundred and thirteen B of chapter one hundred and seventy-five. Such procedure shall have a specified duration of not more than one year but may be renewed by the commissioner upon appropriate findings of fact, conclusions and order. Within thirty days after the close of the hearing the commissioner shall make this determination in a report which shall be made public.

We read clause (i) to deal with a circumstance in which rates might become unjustifiably high and clause (ii) to deal with circumstances in which rates might be too low for competition to operate properly. No participant at the hearing suggested that competition was generating or would generate inadequate rate levels, and accordingly we will focus our attention entirely upon clause (i).

The use of the term "assure" in clause (i) is of great significance. It does not merely require that competition work moderately well. It demands that competition be working well enough to give the public full assurance, in the absence of extraordinary action by the regulator, that rates will not be excessive. The forces of the marketplace must be sufficiently strong that the regulator may refrain from intervention with reasonable confidence that competition, through its normal functioning, will overcome the danger of excessive rates.

The statutory wording obviates the need for a detailed examination of present rate levels to de-

termine whether they are currently excessive in an actuarial sense. We find ourselves sharply differing from the position expressed in the insurer briefs that no finding of competitive insufficiency can be made without such a determination of rate excessiveness. Although a finding that rates were actuarially excessive would be ample grounds for supporting a determination that competition has, in the recent past, been insufficient to provide the required assurance, such a finding is clearly not a necessary condition for a determination under Section 5. The statute's reliance on an assurance test can not be ignored. It is easy to imagine a case in which competition would not be sufficient to assure anything. If, for example, all companies were charging identical prices and refusing to accept new policyholders, competition would not be functioning at all. In this situation antitrust action might well be called for, and it would be superfluous to consider the actuarial soundness of rates in reaching a Section 5 decision. Com-

petition, not being in existence, would not be assuring anything.

The use of the future tense in clause (i) demonstrates legislative recognition of the dynamic character of the competitive process. The burden placed by the statute on competition is to assure that rates will not be excessive in the future. As we read the statute, competition must be sufficient to guarantee that, should loss experience improve as a result of reduced claims, the public would gain the benefit of lowered rates. Likewise, competition must be sufficient to guarantee that a single company, or a close-knit group, could not gain unwarranted market power. Competitive forces must similarly be strong enough to guarantee that, in the long run, inefficient firms will change their ways or exit the market. All of these requirements relate to future effects. No actuarial analysis of present rates could fully illuminate the issue of assurance posed by the statute. Our examination must instead focus on the vigor of the

competitive process as we see it in operation.

We find ourselves just as firmly in disagreement with the insurer contention that competition must be assumed sufficient if each individual company is using a rate justified by its own loss and expense data. To accept this proposition would be to misinterpret the very nature of the competitive process. The benefit of competition to an economic system is fundamentally dependent on its differential impact upon high-efficiency and low-efficiency firms. In a successful competitive market, every company will operate its business in the most efficient possible manner and return a profit commensurate with the market yield on its capital at risk. Inefficiencies and unwarranted profits are driven from the system by consumer choices. Buyers move away from high-priced suppliers of a standardized good and take their business to lower-priced suppliers. Each supplier may be able to justify its cost by its own internal accounting methods, but the discipline of the market is more objective. As democracy depends

on the casting of ballots to move the body politic, so competition depends on the purchasing choices of consumers. Competition has no muscle other than the freedom of consumers to select among sellers.

Remove from a marketplace the ability of consumers to switch suppliers and competition is no longer meaningful. The test of its presence is not that each supplier charges a rate based realistically on its own costs, but that consumer choices and shifts are constantly applying pressure in the direction of increased efficiencies and reduced profits. One insurer may, by virtue of high salary and expense levels, be charging $500 for a package of coverage another carrier with identical consumer services offers for $400. Substantial price differences may likewise arise from variations in the thoroughness and cautiousness of claims investigations. It should not matter that each company may be able to prove its rate actuarially sound based on internal costs. Competition, if it is working properly, must force business away from the less frugal spender

and toward its rival. A market which begins at an even split of customers between the two illustrative companies cited above has an average price of $450. By the time three-fourths of the business has moved to the more frugal company, the average price has fallen to $425. If the entire public transfers its patronage, the average market price falls to $400. It is in exactly this manner that a well-functioning competitive market can assure rates which are not excessive. Only through the dynamics of consumer choice can competition provide the requisite assurance of the statute. The ability of the market to operate accordingly is the principal test we must apply in reaching a decision under Section 5 of Chapter 175E.

We read Section 5 to imply a broad test of competitive sufficiency. If competition is vigorous enough to assure, for the foreseeable future, that market dynamics will constrain rates to prevent excessive returns and to eliminate wasteful inefficiencies, then competition is sufficient. If

the necessary vigor or the prerequisites for market dynamics should be found lacking, the test is failed and a remedy involving regulatory price intervention is called for.

A Test of Workable Competition in Insurance

Economic theory is the best starting point in developing standards for a test of workable competition. Theoretical literature contains ample discussion of the prerequisites for a competitive market. Professor Richard Zeckhauser of Harvard, testifying on behalf of the Attorney General, was helpful in clarifying some of the most important. The first essential ingredient for the existence of competition is a functioning market. The presence of a market is defined by observable interaction between willing buyers and willing sellers. If there is no market, there can never be competition.

The presence of a market alone, though, by no means insures competitive activity. The economist's version of competition depends upon rational behavior, and rationality depends upon knowledge. For a competitive market to function adequately, buyers must be informed as to their costs. No participant in the market, through either sales or purchases, can be allowed to affect the market-clearing price.

All parties must have the freedom to enter and exit the market at will. Buyers must have freedom to choose among suppliers.

To hold any existing market to the textbook standards of perfect competition would be unreasonable. There may be no actual markets which meet all the tests. Recognizing this, economists and other public policy analysts have developed the concept of "workable competition" to describe a less than perfect market, the results of which closely approximate competitive goals. An economist's evaluation of whether workable competition can be found in a market generally begins with an examination of the market's structural characteristics. Then the competitive performance of the market and conduct of the participants are considered. Without attempting to distinguish precisely between the overlapping concepts of performance and conduct in the insurance market, we intend to follow a similar approach.

Structurally, the insurance business appears on

its surface to be a good candidate for competition. More than 110 companies are writing automobile coverages in the Commonwealth. No single company holds more than 10% of the market and no four companies hold more than 35%. There is, however, one troublesome aspect of the structural environment for automobile insurance in Massachusetts. It was suggested in the testimony of Professor Zeckhauser and confirmed in testimony offered on behalf of the Allstate Insurance Company. The problem arises from a questionable compatibility between the demands of competitive theory and the goals of Massachusetts regulatory law.

Competitive insurance markets will set premiums at levels sufficient to cover anticipated costs. Where contract relationships are truly of a single year's duration, standard actuarial techniques may be able to generate acceptable estimates of cost. In Massachusetts, however, contracts effectively run for many years. Under Sections 22E and 22H of Chapter 175, every automobile insurance policy written

must be renewed indefinitely unless the policyholder loses the right to drive, commits fraud on the application or fails to pay a premium. Future risk considerations must, therefore, enter the determination of a seller's willing offer price. Were future risks identical for all classes of business, any premium loading for risk would affect the general level of rates. Loadings for risk in excess of accurately unbiased cost estimates always result in additions to profit margins. A solution yielding overall price levels both justifiable in the short run and market-clearing in the long run might be difficult to derive.

The problem worsens markedly when future risk is unevenly distributed by policyholder class. Reason leads us to suspect that this is the case in Massachusetts. Where rates reach absolute magnitudes in the thousands of dollars, political risk must inevitably be considered. Regulators may demand more exacting justifications for increases in the highest rated classes. Administrative or legislative

mandates to reduce differentials are a constant threat. Thus an unfortunate correlation comes into being. Where rates are high, long-term risks will also be percieved as high. The higher the level of perceived risk, the farther the willing offer price for a long-term contract will diverge from the traditionally computed actuarial price. The divergence of the two prices for a youthful driver in an urban rating territory in Massachusetts might be enormous. We doubt that the offer price would reach the $20,000 figure of Professor Zeckhauser's hyperbole, but we have little doubt that the willing offer price could be well beyond the outer limits of any standard actuarial determination.

Two resolutions are available assuming no change in the statutes. Prices could be allowed to rise to clear the market without regard for conventional actuarial tests of excessiveness. Alternatively, prices could be constrained at actuarial levels with substantial damage to competitive performance. Sellers might be unwilling to offer coverage for

insureds in high-rated classes at the actuarially constrained prices. Each choice appears to contravene one of the Legislature's goals. We read the whole of Chapter 175E as seeking rates which are both competitively determined and actuarially sound. Economic theory, supported by expert testimony, casts doubt on whether simultaneous satisfaction of these goals is realistic in those market sectors where absolute rate levels are a constant source of political turmoil.

The foregoing discussion is highly theoretical. Our decision need not provide a final resolution to the long-run dilemma it poses. Our duty is to reimpose state control over insurance rates should we find competition insufficient whatever the reason. For immediate purposes, it is sufficient to evaluate the vigor of actual competition in 1977. Section 5 must be read as a remedy for dangers resulting from a breakdown in the observable operation of the competitive system. It was clearly intended to provide speedy and temporary relief, limited to

one year as the result of a single proceeding. If long-run experience shows structural infirmities and continuing, persistent need for interim relief measures, the appropriate response will be legislative reconsideration. In the meantime, with some reservations about whether the structure of the insurance market is conducive to workable competition for high risk business, we turn our attention to market performance and the conduct of insurers.

We rest our judgment primarily on three evidentiary determinations. If consumers are not informed of available prices, rational behavior in the market is impaired and competitive discipline is absent. If insurers fail to seek new business, the requisite vigor is almost certainly absent from the competitive process. If insurers are unwilling to accept applicants at posted prices, buyers will be frustrated in their attempts to switch and competitive dynamics will lose their influence over price levels. Factual

evidence is available to help us evaluate the 1977 market for automobile insurance in each of these respects. It is useful to construct the three standards in some detail.

(1) Availability of Price Information

Expert witnesses for a number of participants confirmed that readily available price information is essential to the functioning of competitive markets. When such information is unobtainable or difficult to secure, customers of a particular supplier have no way of knowing the terms under which they could purchase the same commodity elsewhere. This is true whether prices vary as the result of differing costs among companies or because some companies are setting prices above cost. Full information on the rates of competing suppliers is a necessary precondition to any meaningful consumer choice. Were there no other barriers to customer supremacy, lack of information alone would render workable competition unattainable. The test is based entirely on observed conditions in the market

and requires no consideration of the motives of market participants.

Relevant evidence on the availability of price information would include the following: the informational content of advertising; the extent of dissemination of rate information to consumers by direct mail or similar means; the swiftness with which companies informed their agents and existing policyholders of their rates; and the responsiveness of agents and companies to customer inquiries concerning rate information.

(2) Activity of Sellers in New Business Solicitation.

Competition is not a passive concept. It was viewed by Adam Smith, writing in the 18th century, as an independent striving for patronage by various sellers in a market. The Latin root "competere" denotes a simultaneous striving among rivals. It is commonly understood in ordinary usage to involve a perpetual contest among firms for new customers and increased earnings. An economist would expect each firm in a market to actively seek expansion

until new customers could no longer be serviced at a profit. A market in which suppliers simply sit back and wait for business to arrive is necessarily less swift in its competitive discipline than a market characterized by energetic rivals. The efficacy of price regulation by a competitive system is to this extent indexed to the activity of its participating sellers.

Apathy among potential competitors can be indicated by lack of advertising; by written or oral discouragement of increased business; by the filing of rates designed to deter new applicants; and by reluctance to facilitate customer mobility among carriers.

(3) Willingness of Sellers to Accept Business at Posted Prices.

Not every seller at every point in time can be expected to expend large sums for increased market share. Every competitive seller, though, must be willing to accept business at the price it

fixes. Business declination represents a more pernicious form of anti-competitive conduct than does lack of sales activity. When potential applicants are turned away, the seller has proven itself unwilling to participate in the market which necessarily forms the stage for competition. At the same time, it has rendered the available price information meaningless. Evidence of seller unwillingness to accept business must be given substantial weight in any evaluation of competitive markets. Among the signs to look for in the insurance business are: assignments of large numbers of applicants into a uniformly rated high-risk pool; and any limitation on acceptance of business or rejection of legitimate applicants for insurance.

Availability of Price Information

The concern voiced most frequently by consumer participants at the hearing was the difficulty people had in securing accurate and specific rate information. Consumers testified repeatedly that their shopping efforts had been stymied by an inability to obtain price quotations. This was also a principal element of complaints to the Division's Consumer Service Section.

Advertising was one of the subjects addressed in a Division questionnaire sent to all companies writing automobile insurance in the Commonwealth in preparation for this hearing. The responses to the questionnaire were summarized for twenty-two of the twenty-three largest insurers. One insurer's responses were omitted for failure to reply by the required date. The record shows that fourteen of the twenty-two companies, representing 46.2% of the sample volume, did no advertising at all. Examination of the advertisements actually

used by the others showed that 43% made no mention at all of auto insurance. Of those which did mention auto insurance, not one referred specifically to premium rates in either numerical or comparative terms. Virtually no useful price information of the sort required for buyers to participate knowledgably in a competitive market was made available through advertising.

No evidence of any other form of affirmative public dissemination by insurers of rate information was offered. Apparently, no company used direct mail or any similar vehicle for the transmission of rate information to potential customers.

Companies were extremely slow in providing rate information to their agents and their continuing customers. Responses to the Division's questionnaire indicated that no companies had distributed most of their rate manuals earlier than the beginning of the new year. Oral testimony indicated that most companies waited until the threat of Division rate

challenges had been minimized to begin the distributions. The hearing spokesman for the American Mutual Alliance confirmed that even companies whose rates were not challenged waited until year-end to distribute manuals. We view the companies' attitude toward rate manual distribution as a potentially fatal threat to workable competition. Chapter 175E allows challenges by the Division in the period between filing and effective date, challenges by the Division in an available forty-five day suspension period, and challenges at any time thereafter. If companies wait for complete security against rate challenges to distribute information to agents, they can never publish their rate manuals. Even delays pending the relative security of the effective date can be devastating to consumer shopping.

The advantages of waiting must be weighed against the harm to competition. In 1976, consumers had only from the middle of November, when rates were filed, to January 1, when new policies

took effect, to shop without the constraints of a current contract. It was during this period that full rate information would have been most valuable to them. Apparently, for many companies, this was a period of rate silence. It takes an actuary to compute final rates from a filing. No agent or customer can be rationally informed without rate manuals, and no rate manuals were available when they would have been most useful.

Insurance customers are likely to start the shopping process with their accustomed carriers. Availability of price information from the current carrier thus takes on a particular importance as a bench mark. Responses to the questionnaire indicated that most policyholders did not receive bills or policies containing a coverage selections page which itemized the cost of their coverage for two months or more after their policies commenced. Only two companies had ensured that 95% of their policyholders received itemizations or new policies by March 1, 1977.

These findings are in accord with the results of a survey sponsored by Massachusetts Fair Share and the office of the Attorney General. That survey showed 3.5% of respondents to have received bills in December; 11% in January; 27.6% in February; 35.6% in March; and 21.9% in April. Although the survey can not be given the same weight it would deserve had it been based on a scientifically selected sample, it offers useful corroborating evidence to the Division's findings.

Consumers apparently had virtually no way to gather rate information between November and January. Several consumers complained that the estimated cost information they were given by agents or on preliminary bills proved seriously incorrect. Statements of renewal costs were substantially delayed into the new policy year. Even at that time there is reason to doubt that sufficient information was available for meaningful shopping. The survey by the Attorney General and Massachusetts Fair Share was conducted in April of 1977. It found that, of approximately

three hundred consumers who returned questionnaires, less than 20% had been able to obtain comparative rate information.

A second study was then conducted by investigators of the Consumer Protection Division of the Attorney General's Office. They attempted to secure price information from companies and agents by telephone. A total of ninety-two attempts to obtain price information directly from the twenty-three largest insurance companies yielded specific answers from only 12% of the calls. Most companies directed the investigators to contact agents through the telephone book; informed them that no rates were given over the telephone; indicated that only a Facility rate could be given over the telephone; alleged that their insurance quotas were filled; or stated that rate applications had to be filed in the office.

A total of eighty attempts were made to obtain rate information from forty-eight different agents

of the same companies. The investigators failed to obtain pricing information in 78% of the attempts. Of the ten insurance companies writing the largest volume of premium, six refused to provide pricing information during any of the inquiries to company or agent. We find these results convincing evidence of substantial restrictions by sellers on the distribution of rate information.

The results of the Division's questionnaire cast little light on the extent to which rate information has been provided to consumers other than through rate manual distribution. Only one company, with 5.4% of total volume, confirmed instructions to its agents not to provide rate information on consumer inquiries.

We find far more useful the testimony of the Director of the Division's Consumer Service Section. The Consumer Service Section is the first place in the state many consumers will turn to with their insurance problems. The Director testified that the number of calls on auto insurance rose

from approximately 180 a day (60% of 300 calls) to 480 a day (80% of 600 calls) from 1976 to the first quarter of 1977. The Section also received a record 3500 written complaints during 1977's first three months. The Director of such an operation is in a unique position to guage the moods and problems of the auto insurance consumers.

The Director testified that consumers generally liked the idea that the law now permitted comparison shopping for auto insurance. But he also testified that they were "quickly frustrated when they attempted to get rate quotations from any particular insurance company or agent." On the basis of his firsthand experience with large numbers of consumers, he concluded that attempts by buyers to engage in meaningful comparison shopping were "totally thwarted." Because of the continuing, day-to-day experience on which this testimony is based, we find it deserving of substantial attention despite its necessarily non-statistical nature.

Companies responded to questions about the availability of price information in three ways. They argued that meaningful rate information could not be compressed into a form suitable for transmission by advertising or direct mail. They cited a collection of newspaper clippings as evidence that information on rates was widely publicized in the media. They introduced into the record a copy of the Division's 1977 Buyers Guide, which contains a listing of the ten insurers with the lowest statewide average increases. We find none of these responses convincing. While it is certainly the case that rating calculations for all combinations of driver class, territory and vehicle type would be voluminous, rate patterns in any geographical area have sufficient consistency to allow a great deal of useful compression. Whether a company's rates in a particular place are relatively high or relatively low can be readily conveyed in a brief advertisement or mailing. Examples are often worth many pages of rate manual detail.

The references to newspaper coverage and the Division's Buyers Guide are seriously misleading. All of the data contained in these exhibits is statewide data. While meaningful information can be briefly displayed for consumers in any particular location, aggregation on a statewide level is not a substitute for these comparisons. Aetna Casualty and Surety, for example, was one of the ten companies cited in the Buyers Guide for low statewide increases. Yet, in Boston, Aetna's rate increases were among the highest of the more than one hundred companies. Statewide, Aetna's average increase was held to just over 5%. In the Boston territories, it averaged over 45%. Relative rate differentials by territory varied widely among the companies. Rate information for each geographical territory was accordingly of far greater informational content than aggregated figures. The Buyers Guide specifically warns readers not to rely heavily on the statewide averages. They provide only the roughest of starting points in a consumer's search

for the lowest priced supplier.

Both the Division's economist-statistician and the Attorney General's economist laid great emphasis on the importance of readily available price information. The former testified:

> "When we turn to the competitive market structure criterion that consumers be informed about prices and quality, we find an important market failure. For buyers to participate effectively in a competitive market they must have knowledge of the prices charged by different sellers and of the services offered."

The latter testified that, if rates had not been generally available to consumers during the period when they were making their decision on motor vehicle insurance purchases, and, if there had been minimal advertising of rates by either insurance companies or agents, "then competition...is not present...and cannot be adequate to assure that rates will not be excessive."

On the basis of the foregoing evidence, we find that insurers have disseminated little or no useful information through advertising or other direct means, that the distribution of manuals and bills was so late as to have further restricted the opportunity for meaningful shopping, and that consumers have experienced great difficulty in securing the rates necessary for price comparisons from companies and agents. As a result, one of the essential preconditions of effective competitive markets has been found lacking.

Activity of Sellers in Soliciting New Business

While questions of motive are not relevant to our evaluation of informational sufficiency, they are central to an examination of business generation activities. To determine if there has been a healthy competitive rivalry in the insurance market, we must look at the carriers' attitudes towards growth in market share. Energetic advertising campaigns would be among the clearest indicators of a market with the necessary vigor. As we noted earlier, however, advertising was in short supply. We find it disappointing that, in the first year of competitive rating, not one major company engaged in an extensive campaign to increase its market share. We are led to suspect by our findings in every category of evidence that companies instead went to great lengths to hold market shares constant.

Questionnaire responses indicated that eleven of twenty-two companies surveyed, representing 27.5%

of premium volume, openly instructed agents to limit the amount of new auto business taken on in 1977. Twelve of the twenty-two, with 43.5% of the volume, admitted that they "did not encourage" agents to write new business. Roughly half of the companies issued guidelines limiting the amount or type of auto business to be accepted on a voluntary basis.

The Division's Examination Report on Assignments to the Motor Vehicle Insurance Facility, released on May 12 and submitted as an exhibit at this hearing, detailed activities with respect to the Facility of five major insurers who together account for between 10% and 15% of the state's premium volume. The Report found that none of the five companies exhibited any desire to capture a larger share of the market for their own book of business. The Report also found that companies had forced consumers into the Facility on the basis of unfairly discriminatory and arbitrary criteria and that certain classes of risks had

been systematically discriminated against in attempts to limit new business growth. One of the five companies around which the report centered was the Kemper Insurance Company, cited by industry testimony as having experienced substantial market share growth in 1977 because of its relatively low rates. The report stated that "Kemper in fact, bemoaned its grouth of 50,000 policyholders despite an announced goal of no growth of market share."

Another piece of evidence submitted by the Division was a summary of a market situation survey prepared just after the passage of the competitive rating law by the Independent Mutual Agents of New England. The survey's results suggest a long-term and widespread disinclination among insurers to accept new auto business, finding that ninety-five of 194 responding agents had been told by a company in their agency that it would accept no new auto business.

The premium rate changes for 1977 provide an indicator of some companies' attitudes toward new

business in high-risk classifications. Testimony by the Director of the State Rating Bureau, who has had twenty years of experience in actuarial work, emphasized that traditional industry practices call for the capping of sudden and precipitous rate increases. A rate increase in the neighborhood of 25% is usually substituted for any higher increments which may be indicated by pure statistics. The capping is presumably done to prevent shocks to the market system and to allow major adjustments to be made at a publicly acceptable pace. Customer relations are obviously jeopardized when bills embodying massive increases are sent out. We view capping in part as a device for maintaining the loyalty of regular customers and in part as a signal of stability for potential new customers. In Massachusetts in 1977, capping was noticeable in its absence. Rates for property damage coverage rose at the state's single largest writer, the Travelers, an average of 69% for most adult Boston risks. For under-25 male car owners in Boston the

Travelers' property damage rates rose an average of 92%. Other major carriers had similar increases.

There was certainly no legal requirement that companies cap their rates. Industry witnesses correctly pointed out that capping has anti-competitive effects as well as those alluded to by the State Rating Bureau Director. In addition, some companies may, as they claim, have been laboring under a misunderstanding of the Division's preferences with respect to capping. That companies did not cap rates in high-rated classifications would not, taken by itself, be powerful evidence of competitive failure. Taken with all of the other facts on the record, however, we view the enormous rate increases for some risks this year as another of many messages from companies that some types of customers were anything but welcome.

Toward the end of 1976, companies had an excellent opportunity to show their good faith in

making competition work. Aware that customers were having difficulty in coping with the new system in the period prior to rate manual distribution, the Division asked all companies to consider waiving the short rate penalties that would take effect for changes made after January 1. Short rate charges, which are provided for by statute to cover administrative costs of mid-term policy changes, run from 6% for a policy cancelled in its first month of effectiveness, to 5½% for a policy cancelled in its second month, and so on down to ½% for a policy cancelled in its twelfth month.

The Division had requested in writing that these penalties be waived in early 1977. Responses to the Division's questionnaire showed that ten of the twenty-two companies, with 43.8% of the volume, did suspend short rates for some period of time. Seven of the ten suspended the penalties for a month or less, one for two months and two for three months. Unfortunately, those insurers suspending

the penalties generally did not inform their policyholders of the suspensions. Thus, the benefits were more theoretical than actual even where formal cooperation was offered. A long and well publicized period of short-rate suspension following the distribution of rate manuals would have gone quite far in easing the problems of many consumers in 1977. No company demonstrated cooperation to this extent.

On the basis of the evidence before us, we find that the insurance marketplace in 1977 exhibited few signs of vigorous sales activity. Little or no advertising was directed at increasing market share. Agents were actively discouraged in some cases from expanding their business. Rates were set at levels likely to discourage substantial classes of business. The opportunity to facilitate growth of a true marketplace without penalties after rates became available was largely ignored. We can rest little assurance on the sufficiency of competition in any marketplace so devoid of rivalry among suppliers.

Willingness of Sellers to Accept Business at Posted Prices.

The desire for new business as reviewed in the previous section was evaluated as a question of degree. The market would not necessarily have been found to have broken down if only a few of its participants had been passive. Markets break down far more readily, though, if sellers go as far as to actually refuse business. Unwillingness to do business at posted prices is one of the purest forms of anti-competitive behavior. It negates the presence of a market and belies available information.

Massachusetts statute provides that all companies must accept all qualified applicants for the major auto insurance coverages. We did not expect this hearing to produce direct evidence of statutory violations and it did not. Unwillingness to insure, however, can also be imputed indirectly from the difference between volume of new applicants and volume of new writings. Our observations

concern the difference between reasonably anticipated applicant volumes and writings.

Competition thrives only in an atmosphere of consumer choice. Consumers can be expected to "vote with their feet" whenever they perceive a great enough gain from a switch. While price is not the sole criterion for making this sort of decision, hearing testimony confirmed that it would be of great importance in automobile insurance purchasing. The 1977 auto insurance market was replete with price differences of substantial magnitude, as might be anticipated in the case of a system of competition where the forces of convergence have not had time to operate. Companies cited the wide price variance as evidence that their filings were independently prepared. We see no reason to doubt their assertion. In the lowest rated territory, Territory 2, a typical adult policyholder might have seen an available spread, for a standard package of coverage, of over $100.

Kemper, in most classifications the lowest rated company, charged $214 in Territory 2 for the standard package, while the Home Indemnity Company, one of the highest rated carriers, charged $324 for an identical package. In a middle-rated territory, Territory 7, the same driver could have bought the same coverages for $381 from Kemper and for $521 from the Home. In East Boston and Charlestown, which together form Territory 24, the two carriers would have charged $925 and $1324 respectively. Switching, one might think, would be common with so much at stake.

A spokesman for the American Mutual Insurance Alliance identified the hypothetical person most likely to seek a switch as one with a high absolute rate level, an unusually large 1977 increase, and a substantial gain to be had by changing carriers. The under-25 male driver in Territory 24 comes close to fitting the bill. A youthful male in Charlestown or East Boston might pay $3200 for standard coverage

at the Home Indemnity Company. Kemper would write the same coverage for $2100. A benefit of over a thousand dollars is available to reward switching. If switching should have been common as a general practice throught the state, it should have been all the more common among those with so much to gain.

Question 23 of the Division's questionnaire asked for the number of new and renewal policies written for the first quarters of both 1976 and 1977. The compilation of the results, for eighteen of the twenty-two companies in the sample, shows that there were 169,440 new policies written in the first quarter of 1977. This is an increase of 45,321 over the number reported for the like period in 1976, when competitive rating was not in effect. For a market sample of over 1.3 million policyholders, this is a very small number.

With the spread of rates available in 1977, well over 90% of the driving population could have

benefited from change of carriers. Given business loyalties and perceived quality differences among companies, we could not have anticipated all of them to act. When, however, we see such a small increase in the new business rate as we have observed, we must infer that something is amiss. With savings of 20% to 50% available to many consumers and absolute savings of more than a thousand dollars available to some, it is clear that competitive forces were not permitted to function. A high rate paid by a frustrated shopper who should have been able to enjoy a lower rate from another company could be argued to be excessive without any examination of actuarial justifications. The problem may have been lack of information. The absence of selling efforts by insurers may have contributed to the dearth of movement. We are led to suspect, though, that more formidable barriers were in place. While outright refusal was evidenced nowhere on the record, a more subtle form of rejection was plainly in use.

Drivers are assigned, or ceded, to the Motor Vehicle Reinsurance Facility by companies not wishing to write the risks as company business. Gains or losses experienced by the Facility are shared by all companies writing motor vehicle insurance in the Commonwealth in proportion to the volume of their non-ceded business. Risks are ceded in three ways: directly by companies, by companies' appointed agents, and by designated brokers who are able to write only for the Facility.

Although risks ceded directly by companies pay the ceding company's voluntary rates, all other Facility insureds are billed at specially filed rates which do not vary by company. The policies and the billings received by customers show the name of the company and do not indicate to the insureds that they have been assigned to the Facility. Since only 1.7% of 1977 Facility business was ceded directly by companies as

reinsurance business, virtually all ceded insureds are paying the fixed rate. This rate is higher than approximately 80% of companies' voluntary market rates by coverage.

Figures submitted during the hearing show that as of April 1, 1977, Facility cessions amounted to 618,101 policies. This represents fully 25% of Massachusetts exposures. Cessions were up substantially from the preceding year.

Figures on Facility cessions for new and transferred business in the first quarter of 1977 show that the availability problem for shoppers is worse than the aggregate statistics suggest. According to responses to the Division's questionnaire, 38.3% of new policies of twenty-two of the largest companies were ceded to the Facility in the first quarter of 1977 while 17.4% of renewal policies were ceded.

A special examination of ten major insurers, accounting for more than one-third of statewide

premium volume, was completed by the Division shortly before the commencement of the hearing. The results, submitted as an exhibit by the Division's economist-statistician, showed that 34.8% of new policies for over-25 drivers were ceded during the first quarter of 1977, while 55.1% of the under-25 new business was ceded. In this manner, companies apparently frustrated the shopping desires of even the small minority who attempted to switch. Warnings that they would be placed with the Facility rather than at a company rate may have kept away an unknown number of potential applicants as well.

Testimony from both public and company spokesmen confirmed that the number of policyholders insured through the Facility would be expected to decline in a well-functioning competitive market. Instead, it has increased. In the 1977 auto insurance market, many of those buyers who tried to switch companies or who bought insurance for the first time found themselves in the uniformly rated involuntary market.

It stands to reason that many consumers warned of impending Facility placement would change their minds on a planned switch of carriers. Most of those who went ahead, and were ceded by agents, can be presumed to have acted either because their company charged higher rates than the Facility or because they were not properly notified of the agent's or company's intention to cede.

Companies, in their briefs, disputed the usefulness of the Facility data. They argued that their cession techniques were lawful and in accordance with the Facility's approved Plan of Operation. They also cited data from other jurisdictions to demonstrate that the cession percentages in Massachusetts have not been unusually high. Concerning the first point, we note that the Division's Examination Report is in disagreement with the claim of procedural propriety. The legality of cession practices, moreover, is not at issue here. The growth in Facility business is important for its implications with respect to the operation of

competition. Assignment of large numbers of applicants to a uniformly rated pool indicates unwillingness to accept voluntary business whether company procedures were legal or not. The figures from other states carry little weight at this hearing. So many diverse legal frameworks are in place throughout the country that simple comparisons are of minimal value. No testimony was provided to qualify interstate comparisons as meaningful. Our attention should be focused on Massachusetts in the current year, both in absolute terms and in comparison to Massachusetts data for past periods.

On the basis of the evidence presented at the hearing, we find that direct Facility placements were used to reject a high percentage of new applicants in 1977. Contrary to theoretical expectations for an improved competitive climate, use of the Facility increased in 1977 under a new law designed in part to alleviate the system's dependence on an involuntary market. We further

observe that switching of carriers this year occurred to a far lesser degree than should have been reasonably anticipated. While we make no findings with respect to unlawful refusals to insure, we are led to believe that barriers to consumer choice affected more drivers than the number actually ceded. In any event, we find the pattern of Facility placements sufficient grounds to conclude that sellers were unwilling to accept approximately one-fourth of all policyholders and a higher percentage of new applicants at posted prices. Such an environment necessarily implies serious market break-down. As a consequence, assurance of the strength and discipline of competition is lost.

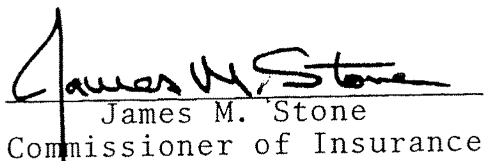
Conclusion

Review of the evidence firmly directs us to a distressing conclusion. The public's hopes for a successful competitive insurance market were not realized in 1977. The necessary information for knowledgeable shopping was unavailable. Companies exhibited little or no vigor in the essential rivalry of the marketplace. Consumers who tried to shop were generally frustrated and many were placed in the involuntary market. We can find no assurance that competition, as now functioning, will prevent rates from being excessive. The disciplinary mechanisms of the marketplace are simply not in sufficient working order.

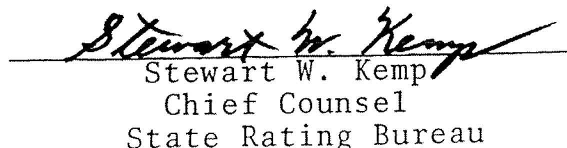
The record, however, lacks the evidence best suited to make a final determination as to the sufficiency of competition by territory and kind, subdivision or class of insurance. The testimony and exhibits contain neither the data nor the arguments on which a reasoned choice of selective relief options could be based. Although the evidence and hearing testimony could support

a determination that competition is insufficient to assure the rates will not be excessive with respect to all territories and classes of insurance, one could make a case for limiting any determination to those market segments where rates and rate increases are highest and market failures are clearest. Of the various hearing participants, only the Attorney General suggested a determination specific to certain classes and territories. The companies' briefs generally argue that the problems of 1977 are transitional in nature. They suggest that time will be a sufficient remedy for any shortcomings we might find in the system. The record does not lend itself to a thorough evaluation of this contention.

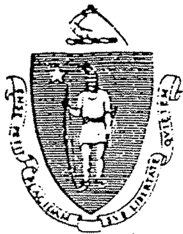
Accordingly, we order that the record be reopened and the hearing reconvened ten days from the date hereof, in accordance with notice to be rendered by the Division, so that we may consider evidence relating to the nature of the final determination to be made under Section 5. This finding has been filed in the office of the Commissioner of Insurance this 16th day of June, 1977.



James M. Stone
Commissioner of Insurance



Stewart W. Kemp
Chief Counsel
State Rating Bureau



The Commonwealth of Massachusetts

Division of Insurance

100 Cambridge Street, Boston 02202

JAMES M. STONE
COMMISSIONER OF INSURANCE

Supplementary Opinion and Decision on the Operation of Competition Among Motor Vehicle Insurers, Rendered August, 1977

On May 19, 1977 a hearing was commenced to consider the sufficiency of competition in the marketplace for automobile insurance. The hearing was held under the authority granted the Commissioner of Insurance by Section 5 of Chapter 175E of the General Laws. On June 16, extensive findings of fact were issued. We concluded for a variety of reasons that competition in the market has not been sufficent to assure that rates will not be excessive. The hearing was reconvened on June 27 to consider evidence relating to the nature of the appropriate final determination to be made under Section 5. Most of the participants in the May hearings appeared at the final session. A number of participants offered legal opinions and their points of view concerning the earlier findings of fact and recommended remedies. No participant offered additional documentary evidence in support of a recommended determination.

All of the insurance company representatives at the hearing voiced a preference that we take no

action to fix and establish rates. Each, however, stated that, if rates were to be fixed anywhere, the Commissioner had no choice, either legally or practically, other than to fix them throughout the state. One insurer's counsel asserted that, unless we were prepared to alter our findings of fact, we would be legally compelled to fix and establish rates in all classifications and territories. The Attorney General took a similar position, indicating that the Commissioner's discretion, based on the findings of fact, was not broad enough to permit waiving the fix-and-establish remedy specified in Section 5. He argued, though, that the discretion of the Commissioner was quite broad in shaping the size and extent of a remedy. The Director of the State Rating Bureau indicated that actuarial difficulties might preclude a mathematically consistent fixing of rates for some classes and territories. He recommended that rates be established by the Commissioner on a statewide basis. In general, no participant, whether consumer spokesman or representative of an insurer, challenged

the Commissioner's legal authority, based on the findings of fact, to fix and establish rates for all territories and classes of motor vehicle insurance. All except counsel for the Attorney General urged statewide action rather than a partial determination limited to certain territories and classes, and he cited statewide action as one of two feasible alternatives.

Reviewing the record as a whole, we find no adequate basis to limit our final determination to any subset of the territories and classes of insurance. The absence of testimony or evidence relating to the operation of competition by territory and class renders almost impossible the task of distinguishing subdivisions where competition is insufficient from those where it may be more successful. While a persuasive public policy argument might tempt us to limit the scope of our final determination, we are unwilling to do so on the strength of the record and in the face of virtual unanimity among the participants that no such limit should be imposed.

We are also mindful of the actuarial difficulties cited by several participants as inherent in partial rate-setting. Traditional methodology derives specific rate levels from a statewide average rate which is then distributed by class and territory according to a complex pattern of multiplicative relativities. If new rates for some classes or territories were fixed by the state while others were competitively determined, the relativities would, most likely, no longer average to one. An average relativity at unity is a precondition for actuarial consistency. Moreover, partial rate-setting might well cause undesirable reversals in the rate structure. For example, the average premium level in a competitive territory might turn out to be higher than that in a territory with state-made rates even though the past experience of the former was undisputedly better than that of the latter. Based on the evidence at this time, we conclude that a partial determination of competitive insufficiency is unsupportable and that the application of a partial remedy is impractical.

We are unable to accept the view pressed by counsel for the American Mutual Insurance Alliance that time alone is an adequate remedy for the problems experienced under competitive rating. While the problems discussed in our June 16 findings may to some extent be transitory, the remedy created by Section 5 is itself of limited duration. In addition, we concur with the Attorney General that the law contains no grant of discretion to waive the prescribed remedy. We can not accept vague assurances from the companies, however well-meaning, that all of the difficulties will be ironed out by next year as a proper substitute for the legally defined remedy.

Before closing the hearing record, we invited all participants to assess the legal impact of pending legislation to provide automobile insurance relief, subsequently enacted as Chapter 365 of the Acts of 1977. The legislation directs reductions

in 1977 rates for insureds in certain geographical areas, those assigned to the Motor Vehicle Reinsurance Facility, and all policyholders whose rates exceeded 1976 levels by more than 25%. The rate relief sections of Chapter 365 cease to be effective on January 1, 1978. They do not address the problems and issues forming the basis of our June 16 findings. The new law does not alter the language of Section 5 of Chapter 175E. The administrative remedy remains mandatory, in our judgement, as long as it has been determined that competition is insufficient.

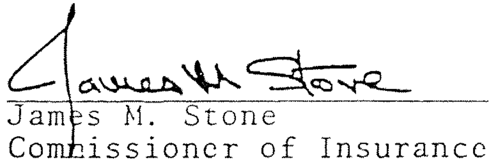
We do not read Chapter 365 as precluding administrative action by the Commissioner of Insurance. We do, however, believe that the legislature hoped its actions would end the controversy over 1977 rates. We are somewhat reluctant to upset the legislatively modified rates in 1977. As a practical matter this decision is probably most useful in relation to next year's rates in any event. In view of the time required to notice and hold a hearing, render a decision, and implement the resulting rates, it would be close to yearend before new rates would be available under normal scheduling. Accordingly, we believe that

the goals of Section 5 are best implemented by an order that 1978 rates be fixed and established by the Commissioner of Insurance.

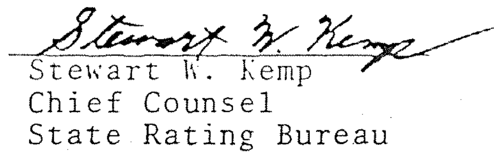
We hereby order that a hearing is to be commenced sixty days hence, pursuant to Section 113B of Chapter 175 and Division Regulation 4-76 for the purpose of fixing and establishing motor vehicle insurance rates for use in 1978.

This decision should not be read as a death sentence for competitive rates in Massachusetts. The law establishing competitive rating remains on the books and will automatically take effect again in one year unless these findings are renewed. This decision is instead a statement that competition, as it presently operates, is insufficient to meet the statutory standard and can not be trusted to regulate rates in the near future. If any participant can, at the commencement of the rate hearing under Section 113B, produce convincing and persuasive evidence that the problems cited here have already been solved, we will reconsider at that time our findings of fact. Otherwise, they will be reconsidered at an appropriate time next year.

This decision has been filed this 5th day of August, 1977 in the office of the Commissioner of Insurance and with the Secretary of State as a public record. Any party aggrieved by this decision may, within twenty days, file a petition for review in the Supreme Judicial Court for the County of Suffolk.



James M. Stone
Commissioner of Insurance



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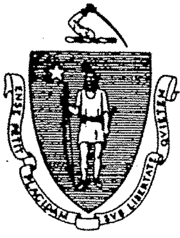


The Commonwealth of Massachusetts

Division of Insurance

100 Cambridge Street, Boston 02202

Michael J. Sabbagh
COMMISSIONER OF INSURANCE

Docket No. R80-5-3

Report of the Determination of the Commissioner of Insurance Relative to the Operation of Competition Among Motor Vehicle Insurers Pursuant to M.G.L. Chapter 175E, Section 5

Filed in the Office of the
Commissioner of Insurance
and with the Secretary of
State, July 28, 1980, 5:00 p.m.

Massachusetts General Laws Chapter 175E, Section 5 empowers the Commissioner of Insurance to hold a public hearing to determine whether competition is sufficient to assure that automobile rates will not be excessive if insurers are allowed to conduct their business in accordance with and be regulated by Chapter 175E. If competition is found to be insufficient, the Commissioner is authorized to suspend the rate-making process allowed the companies under Chapter 175E and continue his rate-making authority, powers, duties and obligations in accordance with the provisions of Section 113B of Chapter 175.

Every year since 1977, Insurance Commissioners of this Commonwealth have held public hearings in an effort to determine whether the motor vehicle insurance environment in this state had progressed sufficiently to assure rate competition among insurers. Through 1980, no Commissioner has found enough evidence to warrant his releasing himself as the rate-maker under said Section 113B. Consequently, except for a brief period - about the first six months of 1977 - Chapter 175E has been suspended and rendered inoperational as a result of hearings held pursuant to Section 5 of said Chapter 175E. (The history of the relationship of M.G.L. Chapter 175E and the Commissioner of Insurance is fairly and accurately set forth in the records of the Division labelled: Opinion and Findings on The Operation of Competition

Among Motor Vehicle Insurers, Rendered June, 1977; Supplementary Opinion and Decision Among Motor Vehicle Insurers, Rendered August, 1977; Opinion, Findings and Decision on The Operation of Competition Among Motor Vehicle Insurers, Rendered June, 1978; and Opinion, Findings and Decision on The Operation of Competition Among Motor Vehicle Insurers, Rendered June, 1979.)

In June of 1980, public hearings were again held in the Division of Insurance after publishing notice in various newspapers and trade journals and sending personal notice to all motor vehicle insurers, insurance agents and brokers, to members of the Great and General Court, the Attorney General of the Commonwealth, the Consumers' Council and other consumer groups, and to a variety of interested parties who had left their names and addresses with the Division requesting personal notice of all public hearings involving motor vehicle insurance.

At the hearing, a number of witnesses appeared to offer their opinions, prepared statements and documents purporting to be the basis and justification for their positions concerning competition. The testimony reflected a wide spectrum of the various interests that would be involved in any changes in the method of setting automobile rates for 1981. All of the testimony and prepared statements which were presented may be classified as falling within three general categories.

Group 1 favors a complete competitive pricing structure for both the private passenger and the commercial classes of the automobile insurance market and urges that I make no findings with reference to competition and thereby allow Chapter 175E to go into effect on January 1, 1981.

Group 2 favors a "phased-in" approach to a competitive pricing structure with a starting date for the commercial class of the market to be established for sometime in calendar year 1981. The principals within this group believe that significant statutory changes in the automobile insurance laws are necessary to create the appropriate atmosphere for competition in underwriting the private passenger class; the urgency for amendment and modification of related statutory laws is not so immediate for the commercial class.

Group 3 is opposed to any competitive pricing structure for 1981 for any class of motor vehicle insurance. This group views the present system of rate making by the Commissioner as the only way for controlling inordinate rate increases, and in support of its position emphasizes the debate created by the insurance companies in 1977 when the then Commissioner allowed competitive rates to be filed under the Chapter 175E.

While Groups 1 and 2 differ in the timetable to be used for instituting competitive rating, they are in agreement that a competitive price structure will in the long run result in

better pricing benefits to more motorists than under our present system. They think that a change to a competitive system will lower premiums for the vast majority of Massachusetts motorists who are accident free but, because of our present laws and the current system which must work in concert, our good motorists are penalized by being required to subsidize the accident prone, careless and reckless motorists - in short the high risk driver who causes and generates poor loss experience. In any event, it is now well established that before any of the above mentioned benefits of a competitive pricing system can be realized, we must be assured that such a system can be implemented either in whole or in part without the chaos, confusion, and unfair premium increases that occurred in 1977.

Group I argues that the existing provisions of Chapter 175E provide the Commissioner with sufficient authority to prevent rates from becoming excessive and to prevent destructive competition and threats to insurer insolvency because of inadequate rates. The Metropolitan Property and Liability Insurance Company stated that "none of those difficulties (the 1977 problems) is traceable to any defect in the provisions of Sections 4, 7, or 8 of Chapter 175E".

It should be noted that the current provisions of Chapter 175E are the exact same provisions that were in effect during the 1977 experiment with a competitive pricing structure.

It is my opinion that Group 1 representatives have focused all of their interest and emphasis on the workability of the provisions of Chapter 175E and are not looking at the entire auto insurance regulatory picture. In their haste to see a competitive price structure implemented and in place, they ignore or minimize the effect of the very real and substantial problems posed for a competitive price structure by related auto insurance laws in Chapter 175. All parties recognize that the so-called "Mandatory Offer" Law (Chapter 175, Section 113C), the "Merit Rating System" (Chapter 175, Section 113P and the Division's Regulations promulgated thereunder) and the "Facility" Law and Plan of Operation as it is presently structured and operates (Chapter 174, Section 113H) must be reconsidered and reevaluated to account for their impact in a competitive market environment. We believe that these considerations are especially relevant to measure their effects upon the Private Passenger class of the automobile market. We are also convinced, in retrospect, that the basic reason for the 1977 fiasco was failure on everyone's part to lay the necessary foundation for introducing, educating, and informing motorists of the details of a competitive pricing system.

Since I find little in the arguments presented by the industry within the Group 1 category to assure that competition among all insurers will produce rates that are not excessive for all the various classes, sub-classes, or kinds of insurance nor to any territory that may be established, or conducted as to be

destructive of competition or detrimental to the solvency of insurers, I am not able to give a blanket approval for a full and complete return to competition as suggested by the proponents in Group 1.

Diametrically opposite the Group 1 advocates are those herein identified as Group 3. Within the Group 3 category are the Senate Chairman of the Joint Legislative Committee on Insurance, Senator McKinnon; the Attorney General; Fair Share; and Senator Alan Sisitsky.

It is their considered opinion that the 1977 experience is proof that competitive rating may never be feasible in Massachusetts because the insurance companies have not seriously undertaken a systematic analysis and planning or disclosed to the Commissioner or the public any program or schedule, for the purpose of effectuating a bona fide, viable competitive pricing system for the motor vehicle insurance market. They also take issue with the Group 1 adherents by noting that a necessary part of any meaningful competitive scheme must include competitive price information for the consumer to be able to make intelligent choices by a comparison of prices. The only area of agreement between the two groups rests upon the need for the amendment of the previously mentioned insurance statutes relating to motor vehicles that are in Chapter 175. All three groups have called to our attention the need to amend the statutory roadblocks in Chapter 175 so as to provide the incentives ncecessary for private enterprise to compete in a free market. Since conditions are not yet conducive to competition, we are urged to continue our direct control over rates under Section 113B of Chapter 175.

We are advised that the automobile insurance market has achieved some rate stability since the 1977 experiment was modified to allow the Commissioner to test the waters by conducting annual proceedings such as this one to determine whether an appropriate environment exists in the Commonwealth to support a competitive price structure. Under the historic "fix and establish" system, they say, the size of rate increases have been tolerable and not excessive, not even as much as the rate of inflation which has so severely affected the prices for all goods and services over the recent past. In their view, history has a habit of repeating itself and 1981 is not the time to test or disprove the proverb with motorists' dollars.

The idea that price competition for automobile insurance is not feasible and will never come to fruition in Massachusetts is difficult to accept. It is well known that automobile rates in every other state are the subject of competition among insurers. Property and casualty lines of insurance, other than automobile, have long been competitively priced in this state. We realize that a "fix and establish" system which has been in existence for more than 50 years is not revisable or made acceptable overnight. The Legislature of this Commonwealth, however, has seen fit to keep Chapter 175E in the General Laws. We understand the intent of the Legislature is, therefore, to attempt to put the automobile insurance system on a competitive scale, as it is in other states and as it is with other lines of insurance in this state. To achieve this intent and purpose, the Insurance Commissioner has been given extraordinary powers which must be exercised with

extraordinary care. It is not prudent to continue in an atmosphere of guess and speculation that inusurance companies will again provoke crisis by irresponsible and irrational rate filings if left to their own devices nor to think that only a Massachusetts Insurance Commissioner has the omniscience, power of "guesstimate" or crystal ball which enables him to come up with rates that are fair to the public, the companies, investors, and other interests. Adopting the view of either opposite extreme will indeed never bring about some deregulation of automobile insurance rates as intended by Chapter 175E. In the very recent past, we have been witness to the effect of price competition in the airlines industry. Prices have dropped dramatically with the withdrawal of governmental rate regulation. Could not lightening strike twice? We aim to find out but not necessarily by following the procedure of the past.

It is my opinion that Chapter 175E should be given a fair chance to operate albeit initially in a restricted environment and further, with a transition period of sufficient length that will determine once and for all whether Massachusetts is unique with respect to automobile insurance pricing.

After considerable study, soul searching, and a straightforward, common sense approach to this matter, I believe that all interests will be best served at this time by adopting the approach suggested by Group 2.

Within the group are counted some of our leading domestic and foreign insurance companies and the two insurance agents' associations who participated in the hearing. They recommend and I adopt the proposal that competition at the level authorized by Chapter 175E be phased in at a digestible rate rather than

reestablishing the open-door policy which proved a disaster in the first and only prior attempt at rate competition in this state.

From the testimony at the hearing and a review of the prior decisions, I am convinced that a viable, competitive rating structure can be made to work in this state if all of the parties, irrespective of their preconceived notions, points of view and self-interest presented at this hearing can meld into a joint effort for the goal. We note, for example, that almost every witness at the hearing testified to the need for the Legislature to re-evaluate and reconsider statutory roadblocks which by and large in their present form may be the single greatest obstacle to obtaining price benefits for the great majority of our motorists. Before a full scale competitive system can operate properly, the so-called "Facility" statute, Section 113H of Chapter 175, needs amending to recognize the quality, kind and types of risks, an insurer in this state is required to assume involuntarily; the costs and efficiency of the "Merit Rating System" as it affects individual company expenses need to be reexamined now in light of some three years of experience of surcharging accident-involved motorists and drivers convicted of violating the laws of the road; and the costs to a careful, accident free, surchargeless motorist who is obliged to subsidize other motorists not of the same class because of the so-called "Mandatory Offer Law."

The main concern with most testimony seems to be the application of competition to the Private Passenger Classification. There is little in the record that discourages allowing competition for the Commercial Classification.

To begin the second attempt at competition, therefore, we now announce a limited suspension of M.G.L. Chapter 175E in accordance with the power granted me in Section 5 thereof.

With respect to the Private Passenger Class, I am not satisfied that conditions of the market place have changed sufficiently at this time to assure me that insurers will compete to the extent that Private Passenger Class rates will not be excessive for 1981. Therefore, the procedures set forth in Chapter 175, Section 113B, wherein the Commissioner of Insurance fixes and establishes rates for compulsory insurance and for certain mandatory optional coverages shall continue for rates to be used during calendar year 1981. Appropriate announcements of the date, time and place of the hearings pursuant to that statute will be published in the near future.

The Commercial Classification, however, is another matter. Conditions for marketing the Commercial Class of business are completely different. Buyers within this class are already in a competitive environment by virtue of their business interests and affiliations. They are continuously exposed to price competition within their individual businesses. To turn a profit, they are necessarily sophisticated business people who are familiar with price comparisons and comparison shopping. To be successful, they have to know how to take advantage of a competitive environment. I am satisfied that insureds in this class should be allowed to shop for the best price the market has to offer.

Effective July 1, 1981, Massachusetts licensed insurers, therefore, will be governed and regulated by the provisions of Chapter 175E with respect to rates for those motor vehicles defined and

described in the Massachusetts Commercial Automobile Insurance Manual which has been approved for use for calendar year 1980.

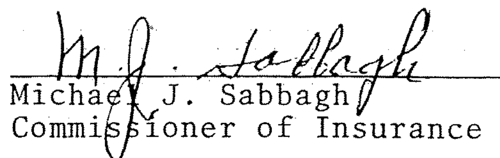
Rate filings for the Commercial Class shall be subject to a timely filing with the Commissioner as required by Section 7 - not less than forty-five days before July 1, 1981 - of Chapter 175E.

As we undertake this step towards a competitive system, we remind all interested parties that we stand ready to cooperate, guide, advise and participate to the extent necessary to succeed in this endeavor. We shall be available to both legislative and industry leaders, to the Attorney General and to consumer groups to report progress in the development of a Massachusetts competitive pricing system.

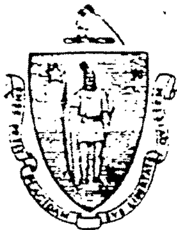
We remind all parties interested in this decision that it will be necessary to consider rates for the Commercial Class in the rate making process under Section 113B of Chapter 175 for that portion of the calendar year 1981 - from January 1 through June 30 - when competition will not yet be in place for either the companies or members of the said class. We believe that a transition period as provided herein is necessary to assure the success of this program.

Filed in the Office of the Commissioner of Insurance and with the Secretary of State on Monday, July 28, 1980, at 5:00 p.m.

This decision may be appealed in accordance with the provisions of M.G.L. Chapter 30A, Section 14.



Michael J. Sabbagh
Commissioner of Insurance



MICHAEL J. SABBAGH
COMMISSIONER OF INSURANCE

The Commonwealth of Massachusetts

Division of Insurance

100 Cambridge Street, Boston 02202

Report of the Determination of the Commissioner of Insurance Relative to the Operation of Competition Among Motor Vehicle Insurers Pursuant to M.G.L. Chapter 175E, Section 5

Filed in the Office of the
Commissioner of Insurance
and with the Secretary of
State, August 13, 1981, at 5 p.m.

This report of the Commissioner of Insurance (Commissioner) is rendered after the close of the public hearing authorized by M.G.L. chapter 175E, section 5. The hearing was held on July 23, 1981 after publication of notice in accordance with the requirements in M.G.L. chapter 30A. Representatives of consumers and other interested parties who appeared and were heard included members of the Great and General Court of the Commonwealth, insurance industry leaders representing both insurance companies and agent and broker organizations, the Office of the Attorney General and the Director of the State Rating Bureau in the Division of Insurance. Each presented facts, opinion, data and views relative to current existing conditions for allowing, not allowing or limiting automobile insurance rate competition among insurers in this state. From the evidence presented at this public hearing and the prior "reports" issued in connection with the sufficiency or insufficiency of rate competition with respect to any territory or to any kind, subdivision or class of insurance, this Commissioner makes the following determination concerning motor vehicle insurance rate competition for calendar year 1982 on the basis of these findings of fact and conclusions.

As of the date of the hearing, the Legislature had not completed its deliberations or consideration of the considerable number of individual bills or of the major motor vehicle insurance

reform proposal submitted by the Governor and amended by the Joint Committee on Insurance all of which are designed to alleviate the major obstacles to extending competition to the private passenger classification.

In July of 1980, it was my considered opinion, after a hearing, that conditions were not yet right to fully implement competitive rating across the board. My best judgement was, and still is, that competitive rating will work in Massachusetts provided the Insurance Commissioner exercises sufficient supervisory authority without over-regulating or impeding the creation of a genuinely competitive market. Toward this end, a "phasing-in" began by allowing companies to prepare to compete for writing the commercial class of motor vehicles. We note that it took almost one year for the companies and the State Rating Bureau in the Division of Insurance to reach the point where competitive rates were actually in place and ready to be used.

In this regard, the Director of the State Rating Bureau testified to the results being achieved with respect to filings made by insurers for the commercial class. The information disclosed by the Director is particularly pertinent as it is our first experience with rate filings from individual companies after our findings and conclusions last year that this state is ready to accept and support a competitive motor vehicle insurance market as limited in that report.

In support of the appropriateness of our 1980 findings and conclusions, with respect to the commercial class, the Director reported that as of the date of the hearing (July 23, 1981) rate approvals have been issued for the following sub-classes of the commercial classification:

Trucks, Trailers and Tractors	-	16 companies
Private Passenger Type Vehicle	-	15 companies
Garages, Liability	-	15 companies
Taxis, Liability	-	14 companies
Motorcycles, Liability	-	14 companies

(for the names of the companies and the percentage change for the particular sub-class which has been approved, see Attachment A to this report.)

The leading underwriters in the state have received approval of their rate filings. We find and are pleased to report a substantial range of rates now exists among insurers writing commercial motor vehicle risks whose filings have been examined and have met the statutory standards in Chapter 175E.

These rate changes and rate ranges are a direct result of the limited deregulation instituted by our 1980 competition report.

The second and equally as important part of this introduction to a competitive system is the assembly, publication and distribution of an informational guide which must be made available

to the consumer shopping for the best price in the marketplace. The informational guide is being readied for distribution so that we anticipate a full-fledged competitive system to be in place allowing consumers to be able to make informed selections from among competing underwriters.

We now turn our attention to market conditions for extending competition to the private passenger classification. The preponderance of the testimony given at the hearing called to my attention that while competition is the wave of the future - of the immediate future, statutory hindrances must be first removed for reasonable expectations of a successful transition to occur. For more than fifty years, the motoring public who register and insure private passenger motor vehicles in this state have grown accustomed to "average-rates" fixed and established by the Commissioner after a hearing as provided by the procedures set forth in Section 113B of Chapter 175. "Average-rates" have meant that all companies, without regard to their own operating methods or particular expense efficiencies have not had to be concerned with rate competition within the industry . That system has led to both excessive and inadequate rates at one and the same time. Some companies have been able to operate profitably, others have not. More important however, our present system has not attracted new companies and new capital to our state. Innovation from the industry that is here is totally lacking. If we did not have our "Merit rating system", accident-free responsible motorists whose business should be attractive to companies would go un-

rewarded. Incomprehensible is the size of the Reinsurance Facility. Risks with good driving records are still being "dumped" in the "facility" because of their place of principal garaging or unfortunate choice of producer representative. Objective standards applicable to the residual market with appropriate rate differentials to distinguish quality of risk is unknown under present rules. It is apparent then, that the present system has only refined inequities, discrimination, abuses, and inefficiencies that can no longer be tolerated.

A substantial amount of testimony at the hearing reiterated prior industry recommendations of the need for statutory reform before real and substantial benefits can accrue to the private passenger class. The statutory obstacles are the same as those identified in our last decision. (July 28, 1980) The "Mandatory Offer" Law (Chapter 175, Section 113C, the "Merit Rating System" (Chapter 175, Section 113H (residual market control law) need priority attention and amendment by the Legislature in order to insure a maximum effort by the industry for obtaining an appropriate environment for rate competition. Once the necessary legislative decisions are made, we stand ready to implement fully rate competition for all policyholders irrespective of class. The regulator must still be held accountable for supervising the marketplace and monitoring the industry to achieve a continuously competitive market system.

Our 1980 "report" initiated the controls and system which we believe and expect will prove successful for the commercial class. The Governor has proposed and the Legislature is now actively considering and evaluating his proposal. The bill contains the required reforms for extending competition for all classifications. It is my best judgement and therefore I conclude that, until such time as the Legislature acts on the pending proposal, the private passenger classification shall remain subject to the rate making procedures still in existence by the terms of Chapter 175, section 113B.

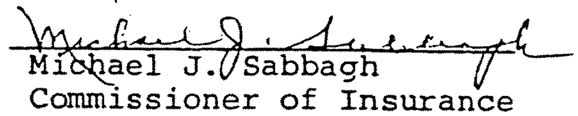
By this decision, we anticipate announcing and holding public hearings relative to private passenger motor vehicle rates for the various coverages, for which the Commissioner is the rate-maker, to be used and charged by all companies for calendar year 1982.

The Commercial Class shall continue to be subject to the provisions of Chapter 175E and the competitive pricing system which went into effect on July 1, 1981.

We wish to advise the Legislature, that subject to their review and consideration of the proposals to remove obstacles to competition, we stand ready to implement fully a competitive pricing system for the private passenger class but that the size of the endeavor will require a transition period of perhaps as long as six months to insure that all interested parties, the motoring public in particular, be sufficiently informed to take advantage of the new auto insurance rate mechanism.

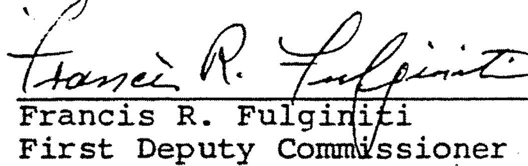
Filed in the office of the Commissioner of Insurance and with the Secretary of State on August 13, 1981.

This decision may be appealed in accordance with the Provisions of Chapter 30A, Section 14.

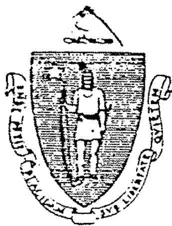


Michael J. Sabbagh
Commissioner of Insurance

Signed in the Presence of



Francis R. Fulginiti
First Deputy Commissioner



The Commonwealth of Massachusetts

Division of Insurance

100 Cambridge Street, Boston 02202

MICHAEL J. SABBAGH
COMMISSIONER OF INSURANCE

REPORT OF THE COMMISSIONER OF INSURANCE RELATIVE TO THE SUFFICIENCY OF COMPETITION WITH RESPECT TO AUTOMOBILE INSURANCE RATES

May 25, 1982

Docket No. 82-3-3

On Thursday, May 6, 1982, a hearing was held in the Boston Office of the Commissioner of Insurance, in accordance with M.G.L. chapter 175E section 5, to obtain evidence from interested parties that competition is either "(i) insufficient to assure that (automobile) rates will not be excessive, or (ii) so conducted as to be destructive of competition or detrimental to the solvency of insurers."

Notice of the hearing was published on March 25, 1982, and, as stated therein, the issue for determination left to the Commissioner is the rate-making procedure to be followed concerning automobile insurance rates for calendar year 1983. In addition, the said notice made reference to the findings and decision of August 13, 1981 and its effect upon the rate-making procedures followed with respect to the private passenger classifications and the commercial class for calendar year 1982.

For the record, 1982 private passenger automobile rates were fixed and established by the Commissioner of Insurance pursuant to the authority granted in M.G.L. chapter 175, section 113B because of a finding, after a hearing, that there was insufficient competition with respect to the said class to assure that rates would not be excessive. However, information that came to our attention through testimony presented at that hearing did not support the same conclusion with respect to the commercial classification. In that decision, we carefully set forth the lengthy planning that had taken place within the State Rating Bureau in the Division of Insurance and the insurance industry to make certain that a competitive system, consistent with the terms in M.G.L. chapter 175E, once in place and understood by the parties involved, had a better than ever chance of succeeding.

From the indications, testimony and record referred to in the testimony of the Director of the State Rating Bureau at this hearing competition among insurers exists in substantial amounts for the various commercial classifications. To summarize, the range of rates now in effect for licensed insurers for the various commercial classifications reported by the Director of the State Rating Bureau are as follows:

Rate levels for the following sub-commercial classes are shown in relation to the rates fixed and established by the Commissioner effective January 1, 1981.

For trucks, tractors and trailers, the overall rate level ranges from +12.6% to -15.4%, with many gradations in between.

For private passenger type vehicles registered and used for commercial purposes the range runs from a +16.2% to -5.0%, again with a large variation by different companies from high to low.

For garage liability, rate levels run from +20.0% to -7.0%.

Taxi rate levels run from +28% to -5.3%.

Motorcycle rate elvels range from +17.3% to -9.5%.

This large variation in rates is a clear indication that competition exists and further, that we are on the threshhold of stiff competition among insurers that seek to attract responsible commercial risks to their doors. Results thus far achieved for the commercial class are encouraging.

We therefore conclude that the competitive efforts of the industry should be allowed to continue in accordance with the guidelines established by the State Rating Bureau.

The private passenger classification however is another story. This classification is the major component of the automobile insurance market in this state. Unfortunately, the class is probably the least informed group of motorists among the various classifications required to purchase motor vehicle coverages. As a result, this group, for the most part, is completely dependent upon insurance agents and brokers for information, coverage and price that is in the motorists best interests. Altogether too often we in the Division are in receipt of numerous complaints from this motoring public describing rating and marketing abuses and improprieties which have resulted in benefits accruing to the producer rather than the consumer. This ignorance must be overcome before a competitive system could hope to be implemented and achieve the success reported thus far for the commercial market.

In the past year we have observed some progress in educating the motoring public of the reasons for the substantial rate levels that have had to be fixed and established by the Insurance Commissioner under the present system. The factors to which we refer have been identified in prior reports.

First is the need to amend certain statutory obstacles that are continued to be perceived as major hindrances to a proper environment for rate competition. The "mandatory offer" law, and the control over the so called residual market is in urgent need of legislative attention. To the extent authorized by law, we in the Division have amended the merit rating system by increasing some of the surcharges for incidents occuring on or after March 8, 1982. We believe this action to be a positive step for encouraging responsible conduct on the highways of the Commonwealth,

To date, however, we have not seen any amendments to those insurance laws referred to above. We are hopeful that the issue is not dead. Encouraged by the statement from the Senate Chairman of the Joint Legislative Committee on Insurance that "Auto insurance reform is still a top priority for me during this legislative session", we anxiously await the needed statutory reforms necessary to produce a truly competitive market.

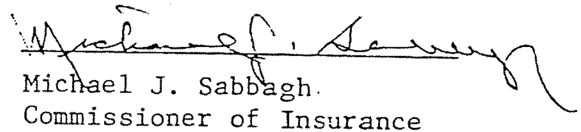
A second and equally important objective needed to introduce a competitive system is a meaningful reduction in the residual market. The residual market in this state for the moment consists of those risks that have been placed in the Massachusetts Motor Vehicle Reinsurance Facility without the application of any standard. We are told that more than 50% of the Massachusetts private passenger classification is insured through the "reinsurance facility". We do not understand how such a large percentage of this class can find themselves in the residual market. This market usually consists of undesirable business that is provided coverage on an involuntary basis. To think that Massachusetts licensed or authorized insurers will not voluntarily insure more than one half of the private passenger classification is strong evidence that a competitive environment is lacking and does not exist at this time. What is needed is a sign, a signal, that the industry is initiating a comprehensive program that will identify a residual market made up of truly sub-standard risks only who would pay their own way without any subsidy from the average motorist within any of the other private passenger sub-classifications. Only then would we be persuaded that a genuine competitive system could begin to form and develop.

Most of the statements read and presented at the hearing from industry sources disclose the effects that may be expected if competition were extended to the private passenger classification. These proponents claim that benefits to consumers would be almost immediate. They could shop for the best product, price and services available. Companies would also be in a better posture to offer competitive prices by adjusting rates to the true costs of doing business in the state. As we are all aware, under our present "fix and establish" system, the Commissioner promulgates rates on an average basis. Efficiencies and cost controls that individual companies adopt as a matter of company policy are lost by policyholders. This kind of initiative is difficult to maintain without appropriate reward. Even though we still favor a competitive system, we are ever mindful of our experience in the recent past with competition generally and with the efforts, planning, and timing that were necessary to accomplish the results reported for the commercial clan. We have not been told, been made aware or know of the existence of any plans, outlines or arrangements contemplated or in place that would duplicate that effort for the private passenger class. We are therefore, not able to find or conclude at this time that there exists an environment or atmosphere conducive to establishing a competitive system for the private passenger class.

We take this opportunity to again advise that we stand ready, willing and able to cooperate, participate and assist in every way with the legislature, the insurance industry and any interested party to prepare and coordinate a smooth transition from the present regulatory system to a competitive system consistent with the provisions of Chapter 175E.

As a result of this report, public hearings will be held in the Division of Insurance, in due course, to consider data, views and agruments which will help and assist the Commissioner of Insurance to fix and establish rates and classifications for the private passenger class and for the various coverages for which the Commissioner is responsible that will be used by all companies during calendar year 1983.

Filed in the office of the Commissioner of Insurance and with the Secretary of State on May 25, 1982.



Michael J. Sabbagh
Commissioner of Insurance

TESTIMONY OF HILARY ROWEN
CHIEF, INSURANCE DIVISION
DEPARTMENT OF THE ATTORNEY GENERAL
AT THE COMPETITION HEARING HELD
PURSUANT TO G.L. c. 175E, §5
MAY 4, 1988

Good morning. My name is Hilary Rowen. I am an Assistant Attorney General and Chief of the Insurance Division in the office of the Attorney General.

The automobile insurance market in Massachusetts today is remarkable for the high level of dissatisfaction of both consumers and insurers. As the regulator charged with determining the extent to which market forces should determine automobile insurance prices, you, Commissioner, must weigh the cost and benefits of continued regulation against the costs and benefits of deregulation. The Attorney General believes that the costs of the current regulatory system are sufficiently high that a phased transition to a more competitive market is in the best interests of consumers.

The testimony presented by the Attorney General at these competition hearings over the past decade has repeatedly emphasized that deregulation is not synonymous with

competition. The benefits of competition, including more serious cost control efforts by insurers and insureds, can only be achieved through a carefully phased plan. This testimony sets forth a regulatory reform plan which we believe will lead to an automobile insurance system which is more beneficial to consumers than the continued fixing and establishing of all automobile insurance rates.

The Attorney General's recommendations include the competitive pricing of optional property damage coverages under a flex rating system which will prevent disruptive premium changes, increased monitoring of claims settlement practices in the residual market, and the determination of individual rates based more on driver experience and less on territory and class. These elements will produce more cost conscious behavior by insurers, lower rates for consumers and a fairer rate structure.

A COMPETITIVE MARKET FOR OPTIONAL PROPERTY DAMAGE COVERAGES

The Attorney General recomends that the Commissioner institute a flex rating system for the optional property damage coverages - collision and comprehensive. Should the experience with this limited introduction of competition prove successful, other coverages should be deregulated in future years.

Introducing competitive pricing on only certain coverages this year limits the potential for market disruption and allows companies and consumers several years to adjust to a fully

competitive market. Thus the Attorney General's proposal is the first step toward the phased introduction of competition to the automobile insurance market. The optional property damage coverages should be selected for the first phase of this effort because the potential savings from the increased efficiency of claims handling and fraud reduction under a competitive market appear to be greatest for those coverages.

STANDARDS FOR MEASURING THE ADEQUACY OF COMPETITION

Pursuant to G.L. c. 175E, §5, the Commissioner must annually determine whether, with respect to any territory or class, competition is either insufficient to assure rates will not be excessive or so conducted as to be destructive of competition or detrimental to insurer solvency. Only after making such a finding can the Commissioner issue a notice for a hearing to fix and establish automobile insurance rates under c. 175 § 113B. In recent years these competition hearings have been an empty formality. Indeed, in some years the Attorney General has presented the only testimony. Our testimony has continually emphasized two themes - the advantages of a competitive market and the dangers of a deregulation effort which is not carefully structured to encourage competitive behavior.

The statutory standard in effect requires the Commissioner to determine whether a viable level of competition can be achieved. (The statutory scheme actually presumes that

competition is preferable to regulation, since it does not explicitly require the Commissioner to determine whether competition will be more beneficial to consumers than continued regulation. Nevertheless, this testimony will also address the question of overall consumer welfare.) In making the determination, whether to continue to fix and establish rates, the Commissioner must look to the current structure of the automobile insurance market to determine the potential for effective competition. Merely examining a highly regulated market for signs of price competition does not satisfy the statutory standard. In a regulated market where prices are fixed and consumers do not comparison shop, companies will engage in non-price competitive methods to maximize profits. The very fact of regulation, thus, significantly distorts the incentives for companies to act efficiently and to provide high quality service at the lowest possible cost.

Legal Authority to Impose Flex Rating

It is undisputed that, under the law, the Commissioner has the authority to determine whether or not to fix and establish the rates as to "any territory or any kind," subdivision or class of automobile insurance. The language of c. 175E, §5, expressly permits the Commissioner to implement a partial or phased introduction of competition. The statutory scheme evidences a legislative preference for competition over a regulated market. It follows that, in order to create a

competitive market, the Commissioner has broad latitude to relax the severe restrictions that fixed and established rates impose on the premiums companies are permitted to charge.

Thus, in the view of the Attorney General, the Commissioner may choose not to set rates for only the optional property damage coverages, may impose a flex rating system, may continue to mandate territories and age symbol relativities and may continue to mandate a safe driver insurance plan - either as an interim measure or on a long-term basis.

SOURCES OF INEFFICIENCY IN THE REGULATED PROVISIONS OF AUTOMOBILE INSURANCE

The regulation of automobile insurance can produce inefficiencies in four major areas. First, companies could provide insurance services in an inefficient manner. Thus, there could be excessive costs in claims processing, administrative expenses or other costs of production. Second, companies other than the lowest cost producers could be providing the service. When a regulated market permits higher cost producers to provide insurance services, the overall efficiency of the system is reduced and costs to consumers are increased. Third, individuals may be getting insurance services that cost more to provide than they are willing to pay for them. Fourth, to the extent that the structure of the regulated market increases the incidence of insurance fraud, a marked inefficiency in the allocation of benefits results.

These four areas of potential inefficiency in a regulated insurance market may interact. Thus, sloppy or high cost claims processing may reduce the barriers to insurance fraud, and to the resulting misallocation of benefits.

The current automobile insurance market is not efficient. The Commissioner in his last two auto decisions found that the industry had not made adequate efforts to control costs and adjusted premiums accordingly. For many years, the Commissioner has applied a "Competition Adjustment Factor" in the calculating of company expense allowances to avoid passing through to consumers high levels of company expenses which would not be incurred in a competitive market. These findings demonstrate that there are excessive costs in the current regulated market.

Administrative attempts to proxy competitive market forces system are not an adequate substitute for the competitive market. First, the regulatory process is unlikely to identify all of the inefficiencies in the regulated market. Second, there is an enormous amount of effort directed to these issues at the fix and establish hearings at the expense of other important aspects of the ratemaking process. Cost containment issues are a major force in the lengthening of the hearing process in recent years. Third, companies are likely to respond to administratively imposed financial penalties through efforts to change the administrative decision through appeals or future rate hearings, rather than through efforts to control the excessive costs.

The current market also does not reward low cost producers. Direct writers (companies who do not use agents) charge the same premiums as agency companies even though they have lower costs. The lower costs of direct writers, therefore, are not passed on to consumers. Agents' commissions are fixed by the Commissioner and cannot be reduced by companies or rebated to consumers (although they can be increased by profit sharing plans).

Perhaps most significantly, the loss sharing mechanism used by CAR does not facilitate the cost conscious settlement of claims. CAR insures 55% of Massachusetts drivers. These drivers pay the same premiums as drivers in the voluntary market, and have their claims managed by 26 servicing carriers. There are no limitations on the reasons - or lack of reasons - for a company to cede a policy into CAR. The CAR deficit is distributed among all companies writing automobile insurance based on complicated formulas which reflect historical market share and credits for voluntarily writing drivers from high rated territories. Thus, the deficit allocation formulas favor companies who increase market share and write drivers from urban areas and penalize companies who lose market share and cede urban drivers. In spite of these incentives, most urban drivers are in CAR because the industry perceives those territories to be underpriced.

The current insurance system subsidizes drivers in high rated territories, experienced drivers and drivers who have

surcharges or are in the zero point class. All of these subsidies are sources of inefficiency in the insurance market and therefore should be scrutinized closely. The Attorney General believes that public policy considerations justify the continued subsidy of high rated territories and, to some extent, of inexperienced drivers. However, the continued subsidy of surcharged and zero point drivers is not justified.

In summary, the current automobile insurance situation is not satisfactory for either consumers or insurers. Under continued regulation, consumers face further substantial rate increases and a reduction in insurance availability. The current system furthers inefficient company conduct, and thereby imposes higher costs than necessary on consumers.

THE IMPACT OF COMPETITIVE PRICING ON THE MASSACHUSETTS AUTOMOBILE INDUSTRY MARKET

It is the most common experience of regulated industries that once regulated such industries will oppose the return to a competitive market. The creation of a competitive market forces companies to change their behavior, often in quite drastic ways, since the strategies which maximize profits under a competitive market are different from those which are most effective under a regulated market.

The examples of trucking deregulation and airline deregulation aptly illustrate this point. The markets for interstate trucking and interstate air travel have been transformed in the last decade. The winners in the deregulated

environment have been different companies than the major beneficiaries of regulation. It should be noted that the number of providers expanded markedly under trucking deregulation, but has contracted under airline deregulation. The degree of market concentration is a function of the underlying industry economics, not of the introduction of competitive pricing per se. Given the relative ease of entry into the property/casualty insurance industry, the expectation is that the introduction of a competitive market in Massachusetts will tend to increase the number of companies writing auto insurance.

Although price-setting regulation is appropriate in sections of the economy (e.g., utilities), where one producer has great market power, this is not the case for automobile insurance. In Massachusetts there are over 100 insurance companies writing private passenger automobile insurance policies. The costs of entry into the insurance business are not great. By any traditional measure, the industry is one that could readily be competitive.

The expected results of the introduction of workable competition to the automobile insurance market are increased company efficiency, reduction in fraud, and increased fairness to both insurers and consumers.

Cost Savings

It is well known that organizations tend to be substantially less cost-conscious when functioning in regulated markets. It becomes considerably easier for them to pass along increased costs to their customers. It is also true that maximum permissible rates tend to become standard rates. Even if a company tried to reduce its costs and prices, it would find that most customers were not shopping around. All in all, the evidence implies that regulated industries are likely to have larger bureaucracies and be less attentive to cost than companies operating in a competitive market.

Fraud

In a competitive market, the number of fraudulent claims could be significantly reduced as companies would have a greater incentive to initiate effective antifraud programs. Moreover, servicing carriers currently have no meaningful incentive to devote resources to investigating possible fraud in ceded business. To the extent that competitive pricing reduced the level of CAR cessions, the overall auto insurance fraud level in the Commonwealth could be reduced.

Equity

Workable competition will provide equity gains in two respects. The first is equity between the companies and the insureds. Under a regulated system, the two groups will always be disputing whether rates are appropriate, i.e., offer a

reasonable, excessive or insufficient return on capital. We have seen that process in Massachusetts.

A truly competitive market pushes rates down to the lowest level that is consistent with companies earning a sufficient return to justify their capital investment -- that is, the lowest level that leaves them any incentive to stay in the market.

The second equity gain offered by competition is increased fairness among drivers. Under the present system, there are substantial cross subsidies in insurance rates. The insurance companies expect to lose money on some classes of drivers and to make money on others. The introduction of competition will require a closer scrutiny of the existing subsidies to determine whether they are justified. Only the subsidies which can be justified on public policy grounds should be retained.

THE FIASCO OF 1977

Any competitive rating proposal will inevitably be discussed in light of the experience in 1977. In the fall of 1976, the then Commissioner of Insurance, James Stone, determined that a competitive market ought to be able to function in Massachusetts and announced that he would not fix and establish rates for the following year. Companies were given very little notice of this major change and no restrictions were imposed on the levels of rate increases. The inevitable occurred: rates for drivers in high rates

territories, especially inexperienced drivers, increased by as much as 100%. The Legislature, facing a crisis, reimposed fixed and established rates, and required that the Commissione retroactively set rates for 1977. An examination of the 1977 experience is illuminating. While some urban rates rose by unacceptable amounts, the statewide average rate increase was in the range of 10%. The Attorney General therefore recommends that the flex rating limits be applied to each class/territory cell rate, not merely to the statewide average rate for the optional coverages. Thus, in allowing companies to set their own rates for optional coverages, the Commissioner can be assured that the events of 1977 will not be repeated.

THE BENEFITS OF COMPETITION

It is desirable for Massachusetts to move to a competitive automobile insurance market. However, the deregulation of rates will not automatically lead to competition. The potential benefits of abandoning the rate setting system would come from the creation of a competitive market, and not from deregulation per se.

Competition has enormous potential to improve service in the auto insurance market, diminish fraud, lower prices, and allocate resources more efficiently.

The Relative Absence of Barriers to Competition

The major barrier to competition in most markets is that individual producers may secure market power. That is, the

producers with market power can hold onto their customers even if the prices they charge for the products they deliver are higher than the prices that others charge, or could charge if given the opportunity. There is no inherent reason why any firm in the Massachusetts auto insurance industry should have market power.

If there were significant economies of scale relative to the size of the market in the delivery of insurance, one company might threaten to dominate the market. Fortunately, this is not the case. Relatively small insurance companies, unlike small automobile firms, can produce insurance services as inexpensively as large companies. Fortunately, we are not faced with a situation in which one or two insurance companies serve the overwhelming majority of the public. There are enough companies in the market to compete vigorously.

The objective is to have workable competition, in which companies legitimately compete with one another to try to secure the business of customers, and customers can be informed about the price and service quality of different insurers.

Antitrust Issues and the Role of Rating Organizations

Currently, the Massachusetts Automobile Rating and Accident Prevention Bureau (MARB) prepares a rate filing for all its member companies - the 110 companies who write private passenger automobile insurance in Massachussets. Prior to preparing its filing, the MARB edits and compiles the data

collected by CAR, the Commissioner's designated statistical agent. In order for a competitive market to develop the role of the MARB and other rating organizations, it should be limited strictly to the compilation of the historical loss experience from Massachusetts auto policies. The compiled, but unanalyzed data would be made available to all Massachusetts automobile insurers as a source of information for rate making.

Creating a Competitive Market

One fundamental assumption of this proposal is that deregulation is not synonymous with competition. A second fundamental assumption is that, after years of operating in a highly regulated environment, both insurers and companies will need time to develop the appropriate response to a competitive environment. Merely removing regulation after a long period of government controls will not immediately or necessarily result in competition.

Deregulation can mean a great variety of things, depending on what type of regulation is being removed and what forces will exist in the market once the regulation is removed. How competitive the post-regulation market becomes depends on the technology of the industry and the remaining regulatory structure.

As has been stated above, even a total removal of all regulation would not instantly and automatically create a situation of vigorous competition. To usher in competition at

the smallest possible cost will require careful thought and planning. Quite simply, the citizens of Massachusetts are not used to shopping for insurance. They need some experience with market forces before they can become effective market participants, which they must if competition is to work properly. Similarly, the insurance companies in Massachusetts have virtually no experience with competition in the private passenger auto insurance market. It will take the insurance companies time to develop appropriate behaviors and effective strategies. Thus, the Attorney General recommends that the Commissioner start by introducing competitive pricing for the optional property damage insurance coverages and letting consumers gain experience in shopping around on a limited basis. If the experience with competitive pricing of the collision and comprehensive coverages proves successful, further steps toward a competitive market could proceed in future years.

Preparing For Competition

A number of specific steps can be taken to minimize the disruption and costs of the transition to competition. First, we must have a definitive date for the transition, with a reasonable lead time, so that companies and consumers can prepare themselves for the new competitive rating. Second, we must develop methods that will facilitate the rapid flow of adequate information in the market. Poor information is a

significant impediment to a genuinely competitive market for insurance. The Commissioner should continue to fix coverages and classes and territories. The Commissioner can also take active steps to assist consumers in locating the lowest priced collision and comprehensive insurance.

The phased introduction of competition proposed by the Attorney General gives consumers, insurance companies and the state government the ability to accommodate gradually to new circumstances.

The Optional Property Damage Coverages

The logical first candidates for competitive pricing are the optional coverages, for with them mispricing leads to the greatest inefficiencies. Moreover, they offer the least compelling arguments for any governmental participation in the market.

There are two possible arguments against limiting competitive pricing to only the optional property damage coverages. In the view of the Attorney General, neither is a sufficient reason for the Commissioner to forego the opportunity for a phased transition to competitive market. The first is the incentive for cost shifting between regulated and unregulated coverages. To the extent that a company perceives rates for regulated coverages to be inadequate in a given class/territory cell, it may attempt to load the differential into the unregulated coverages. The existence of flex rating

limits, however, minimizes the cost to consumers if this occurs. The second potential cost of competitive pricing only some coverages is the muting of the incentives for consumers to shop for the lowest rate. Since competitive shopping is central to the creation of price competition, it is important that insureds actually seek out the lowest premiums. The optional property damage coverages are a significantly large percentage of premium (approximately 45% for people who purchase a full package of coverages) that there will be sufficient incentive for comparison shopping. Furthermore, regulatory action to reduce the costs to consumers of obtaining cost comparison information will probably more than offset the reduced incentives for comparison shopping which arise from competitively pricing only some coverages.

THE PHASED COMPETITIVE PRICING PLAN

The proposed competitive pricing plan has several, intrinsically linked components concerning flex rating, consumer information and new controls on the residual market.

This proposal envisioned a gradual removal of regulatory limitations over a three to five year period. During this period, competitive pricing would be introduced for the mandatory coverages and the other optional coverages and undesirable subsidies (for example, the subsidy of bad drivers by good drivers under the current SDIP) would be phased out. Companies would face increased pressure to be cost conscious

under price competition and consumers would learn how to comparison shop for automobile insurance. Even after the transition period, some regulatory limits would remain. Flex limits, possibly at higher levels than during the transition period, could be continued in order to protect consumers from the vagaries of the underwriting cycle. Prohibitions against invidious discriminations, such as the use of sex as a rating factor, would be continued. A long-term subsidy of the residual market would be provided to assure access to affordable insurance for clean record drivers in high rated areas.

Flex Rating

The regulation of the optional property damage coverages would change from rates fixed and established by the Commissioner, to rates determined by each company and filed with the Division of Insurance. Under flex rating, rates which fall within the flex rating limits will be approved automatically and will be immediately effective. The form of filing for rates within the flex rating limits would be extremely simple. No actuarial justification for the rate would be required. Thus, even companies with very small market shares would not be burdened by the costs of preparing rate filings.

Rates beyond the flex rating limits would require more extensive filings with actuarial support. The Commissioner

would establish procedures for the review of filings beyond the flex limits. These procedures should provide the Attorney General and the State Rating Bureau with an opportunity to challenge the filed rates and the insurer with the opportunity to defend its filing, but would not necessarily require a full blown hearing on each rate outside the flex limits.

The flex limit would operate so that increases within the cap not taken in one year could be carried over to future years. For example, if the flex limits were established as 10% per year for the first three years of this regulatory reform, a company which raised rates by 8% in the first year would be able to raise rates by 12% in the second year if it wished without exceeding the flex limit. This structure reduces the tendency for insurers automatically to raise rates to the maximum flex limits. The flex rating limits would apply to individual class/territory cells rather than the state-wide average rate. ("Cell" refers to a class/territory combination; for example, experienced drivers in territory 16.)

The flex rating limits would be tighter during the transition than after a competitive market had developed. During the transition period, the flex limits protect consumers from excessive rate increases by companies which have not yet felt market pressure to price competitively. After a competitive market is established, flex rating protects consumers from the rates swings typical of the underwriting cycle.

Setting the Flex Limit

The flex limit should be tight enough to prevent excessive and disruptive rate changes, but loose enough to create options for consumers. An examination of the rate changes for collision and comprehensive proposed by the parties to the fix and establish hearings in recent years suggests that a flex range of plus or minus 10% would be reasonable. It would be appropriate for the Commissioner to hold a hearing to solicit the views of other parties on the most appropriate flex range.

Consumer Information

During the transition period from a regulated to a competitive market, the chief difficulty will be getting companies, insureds and agents to start behaving in a reasonably competitive manner. To facilitate the creation of a workably competitive market, companies and consumers who behave in a competitive fashion should be immediately rewarded. The best way to assure such rewards is to attend to the flow of information through the market. If we expect companies to lower their prices as far as they can while still making a profit, they must have some low cost means of informing potential customers that their price is lower than than of competitors. Yet in Massachusetts at present, few individuals know what various companies would charge to provide them insurance. They are likely to be equally ill informed on how good the services are that various companies will provide.

Such ignorance of comparative prices is both understandable and excusable in our present regulated market. Customers could not expect to find considerable differentials in price. A market can only be competitive, however, if a considerable proportion of customers do shop for price.

Good consumer information is essential to the success of the deregulation effort. Currently all companies charge the same price, and consumers do not need to comparison shop. Under deregulation, consumers will need to identify the lowest cost company for themselves. Unfortunately, the existing independent insurance agent system is not likely to provide such information. Unlike travel agents, who can write tickets for all airlines, each insurance agent only serves a small number of companies. Thus, during the transition to competition, consumers will need a separate source of price information and may well have to change agents in order to purchase the lowest cost insurance.

One approach to providing the necessary consumer information is for the Commonwealth to establish, under the auspices of the Office of Consumer Affairs, a center for the dissemination of information collected in the rates filed by each company. A consumer seeking access to such information will be able to call a telephone hotline. After reporting place of garaging, years of driving experience, whether the premium is to be financed, make and model of car, and other relevant data, the consumer would receive a computer generated

list of insurance companies with the lowest premiums, and the name/numbers of the local insurance agents representing each company. The hotline would have to tie into the Merit Rating Board to determine the SDIP status of the insured and listed operators.

With some coordination of the information flow, there is no reason why we should not have a reasonably successful competitive system operating for 1989. Companies should have a few months to prepare themselves for competition, and to file collision and comprehensive rates with the Division. Customers should be able to start comparison shopping several months before the rate year begins.

The costs of transition will be small if we reach a reasonably competitive outcome for collision and comprehensive in the first year. Though the market might be less than fully competitive the first year, it would still be substantially more efficient than the highly regulated market it replaces.

Standard Coverages and Classifications

The Commissioner should continue to mandate a standard automobile policy. Comparison shopping will be virtually impossible if consumers are comparing different products.

The Commissioner should also continue to establish territories and classifications under the first phase of the introduction of competition. However, if the initial experience with competitive pricing is successful, companies

should be permitted some discretion to use non-standard rating factors. One advantage of a competitive market is innovation. We would like to see new approaches to low mileage discounts, driving record surcharges, geographic territory, etc. Over a three to five year period insurers would become responsible for establishing their own rating systems, provided that they did not use age, sex or marital status (which are prohibited by law). Such innovations would be subject to the prior approval of the Commissioner as at present.

It is likely that only the larger insurers will make any innovations in the rating structure because of the significant cost of developing new rate structures. Smaller companies are likely to continue the current system, imitate larger companies, or track the rate structure approved for CAR.

It is critical that new factors be introduced slowly to avoid overloading both insurers and companies. During the first year of the transition, the Commissioner would continue to establish rating classes and territories. In addition, it is desirable to use uniform, state mandated surcharge and credit levels during the first year. (This is analogous to using state-mandated class-territory relativities as well as the state mandated class and territory definitions.) In addition, during the first year, the Commissioner should fix the automobile model year relativities used to price collision and comprehensive coverages. The chief reason for these limitations is to reduce the aspects of the rating system which are in flux during the critical first year.

THE RESIDUAL MARKET

By far the most difficult problem in designing a workable competitive pricing plan is the treatment of the residual market. There are two separate issues relating to the residual market under competition. The first is the efficiency of the residual market. The second is the treatment of drivers currently insured through CAR.

Incentives for Cost Control in the Residual Market

Currently 55% of the drivers in Massachusetts have been denied insurance in the voluntary market and are insured through CAR. We believe that the current loss sharing mechanism, whereby the companies which service ceded policies are responsible for only a small fraction of the claims dollars paid, creates incentives for overpayments of claims on ceded policies.

Ideally, the incentives for overpaying ceded claims would be eliminated by going to a risk sharing form of residual market such as an assigned risk plan. Under assigned risk plans consumers who are unable to purchase insurance in the voluntary market are randomly assigned to Massachusetts insurers in proportion to those insurers' voluntary market shares. The insurer would be fully responsible for paying all claims incurred by the assigned risk driver. Thus, each insurer would have the same incentive to police ceded and voluntarily written claims. The existing statutes governing

the residual market mechanism effectively preclude the Commissioner from creating an assigned risk plan through administrative action.

However, the Commissioner does have the authority to hold CAR accountable for the performance of servicing carriers. At present, servicing carriers are not subject to rigorous performance standards. The creation and enforcement of such standards, with company-specific financial penalties, is essential to cost control in the residual market.

Competition will significantly increase the incentives for insurers to control costs. The introduction of competitive rating for optional coverages will be far more effective than the Commissioner's admonitions and even c. 622 rate reductions in motivating cost conscious behavior.

However, a competitive market will only have a very indirect effect on the handling of ceded claims. The free rider problem will keep servicing carriers from devoting the same level of enhanced cost control programs to the involuntary market as to the voluntary market. Increased incentives for residual market cost controls would be desirable even under continued fix and establish regulation. However, under competitive pricing, the gap between voluntary and ceded market losses is likely to increase as efficiency of the voluntary market improves. Thus, performance standards for servicing carriers are especially important under competitive rating.

Pricing the Residual Market

At present there is no rate distinction by cell between drivers in the voluntary and residual market. (CAR drivers, on average, pay higher rates because they are more likely than voluntary drivers to be from high rated territories, inexperienced classes or surcharged.) In a competitive market, the Attorney General recommends that rates in the residual market continue to be set by the Commissioner. These rates should bear a reasonable relation to the voluntary market rates. They should not be lower than the voluntary market rates or the consumers will seek to be ceded in order to get the lowest rates. However, neither should such rates be set solely on the basis of CAR experience. Currently, a large number of drivers in CAR are no riskier than drivers in the voluntary market. Eventually under competition, those average and better than average risks in CAR will be sought out by competing companies.

The Attorney General recommends that in 1989 the residual market rates be set at the flex rating limit. For example, if the Commissioner determined that a 10 percent flex rating cap on optional property charge coverages was appropriate for the voluntary market, he would increase the residual market rates for these coverages by 10 percent.

It is appropriate for the Commissioner to permit the possibility of a small rate differential between CAR and voluntary premiums on the optional third party coverages by

setting CAR rates at the top of the flex rate range. (Of course, if all companies filed voluntary rates at the top of the flex range, there would be no differential between ceded and voluntary rates.)

Subsidies in the Residual Market

In general, it is preferable the subsidy of the residual market should be transferred through mandatory, rather than optional, coverages. When for public policy reasons the decision is made to create a subsidy, it is wise to do so, if possible, on coverages where people's level of purchase will not change much (that is, where the elasticity of demand is low). Since all vehicles by law must be insured, subsidies directed to the manditory coverages will not inappropriately distort purchase decisions. In addition, subsidies should be directed toward third-party as opposed to first-party coverages. The social cost of pervasive under- or un-insuring of the liability coverages would probably exceed the cost of subsidizing the residual market.

In 1989, the Commissioner would continue to provide a full subsidy of the mandatory coverages for drivers in CAR through the fix and establish mechanism.

CONCLUSION

The Attorney General recommends that the Commissioner take the necessary first steps toward creating a competitive market

for private passenger automobile insurance. The Commissioner should, in his competition decision, order the establishment of a flex rating system for the optional property damage coverages for the 1989 rate year. The Attorney General submits that a flex range of plus or minus 10% would be appropriate. However, the choice of the flex limits is within the Commissioner's discretion and could be established after seeking the views of other interested parties at a subsequent hearing.

In order to facilitate the creation of a competitive market, the Commissioner should impose strict performance standards on the CAR servicing carriers and should work with the industry and agents to create an accessible consumer information system to facilitate comparison shopping.

The fix and establish system is breaking down. The rate hearings have become inordinately long and increasingly complex. Allowing companies to set their own rates within flex limits, even with the review of filings outside the flex limits, would utilize the Division's resources far more effectively than the fix and establish system. For example, much of the hearing time in the last two years has been absorbed by "cost containment" issues. A workable competitive market will contain costs far more effectively than the administrative process.

More importantly, the fix and establish system has not produced a stable, cost sensitive insurance market in Massachusetts. Premiums are exorbitant, cost controls are

sorely lacking, and insurers are withdrawing from the market. The potential costs to both consumers and insurers of the phased introduction of competition are significantly smaller than the costs of continued fixed and established automobile insurance rates. I therefore urge you, Commmissioner, to give very serious consideration to the proposals in this testimony.

Docket

OPINION, FINDINGS AND DECISION ON THE OPERATION OF COMPETITION AMONG MOTOR VEHICLE INSURERS

Rendered June 28, 1989

Docket Number G-89-8

In accordance with G.L. c. 175E, §5, a hearing notice was issued by the Division of Insurance ("the Division") on April 10, 1989 and Commissioner Roger Singer conducted a public hearing at 10:00 a.m. on May 10, 1989 to consider whether the fix-and-establish ratesetting procedure used to set 1989 private passenger automobile insurance rates should be renewed to set 1990 rates. The record of the hearing was left open until May 12, 1989. That record has been carefully reviewed in the preparation of this decision.

Under Section 5 of Chapter 175E, if the Commissioner of Insurance ("the Commissioner") determines, with respect to any territory or to any kind, subdivision or class of motor vehicle insurance, that competition is either i) insufficient to assure that rates will not be excessive, or ii) so conducted as to be destructive of competition or detrimental to the solvency of insurers, he shall fix and establish the rates for such insurance or territory pursuant to G.L. c. 175, §113B.

For the past 12 years the Commissioner has determined that competition has been insufficient to assure that insurance rates would not be excessive for private passenger automobile insurance. Each year the Commissioner has ordered that rates for the following year be fixed and established.

Last year, for the first time in many years, there was

renewed interest in the concept of a transition to a more competitive private passenger automobile insurance market. The Attorney General ("AG") submitted a proposal to introduce limited competition in the 1989 rate year. The American Insurance Association ("AIA") and the National Association of Independent Insurers ("NAII") also advocated a gradual move toward competitive rating. The State Rating Bureau ("SRB") and two agents associations, Independent Insurance Agents of Massachusetts ("IIAM") and Professional Insurance Agents of New England ("PIA"), opposed a return to competitive rates for 1989. Commissioner Singer found a number of problems with the specific proposals that were introduced last year, in light of the conditions in the market at the time. Consequently, the Commissioner ordered that the fix and establish ratemaking procedure set forth in G.L. c. 175, §113B be continued for all coverages for calendar year 1989. However, the Commissioner did encourage the development of workable alternatives to the fix-and-establish procedure.

This year, this hearing also generated considerable interest, and several new proposals to introduce some type of limited competition were presented. Oral and/or written testimony was submitted by Senator John Houston, IIAM, PIA, AIA, the AG, the SRB, the Massachusetts Automobile Rating and Accident Prevention Bureau ("MARB") and CNA Insurance Companies.

Since any proposal to return to competition must be

evaluated in light of the current market conditions, I will briefly note three factors in the current market which were pointed out in the testimony and are of particular significance this year: 1) the size of the residual market; 2) company withdrawals; and 3) the recent enactment and ongoing implementation of auto reform legislation, Chapter 273 of the Acts of 1988 ("Chapter 273").

As was stated in almost all of the testimony, the size of the residual market continues to be of serious concern. Currently, approximately two-thirds of the private passenger automobile insurance risks are ceded to Commonwealth Automobile Reinsurers ("CAR"). Therefore, it is essential that any proposal to introduce competition be examined and evaluated in relation to how it will effect the rates for the risks currently ceded to CAR, the proportion of risks ceded to CAR and the size of the deficit.

This type of analysis is complicated this year by the fact that as a result of Chapter 273 there may be significant revisions to CAR which will be implemented in January 1990. Section 66 of Chapter 273 requires the Commissioner of Insurance to prepare a report for the Legislature by September 1, 1989 with specific proposals to revise CAR. The Division began the reform process on May 24, 1989, by holding an informational hearing to solicit proposals for revisions to CAR. A number of witnesses at the competition hearing

discussed the relationship between the timing of CAR reforms and the implementation of any type of competition.

Many of the witnesses noted that nine insurance companies have withdrawn or have attempted to withdraw from Massachusetts in the past three years. The withdrawing companies have pointed to their losses in the automobile insurance market as their principal reason for seeking to leave the state. Four of the withdrawals were announced in the past year alone. There is no dispute that this type of exodus, representing approximately 23 percent of the market, continues to have a significant impact on the market.

Finally, Chapter 273, which was enacted last year and is currently being implemented, has introduced a number of significant changes to the automobile insurance system for consumers, the industry and the system at large. It changed coverage and deductible options and it required the implementation of new programs, such as pre-inspection and direct payment plans. The effects of most of these changes are not yet known.

The witnesses differ in their opinions as to whether a return to competitive rating should be ordered for the 1990 rate year. Senator John Houston opposes a return to competition because it was his opinion that the type of competition being advocated will have the effect of raising rates and will therefore not benefit consumers. Senator

Houston advocates the introduction of what he called "cost-cutting competition". He gives as examples two concepts which will require legislative as well as administrative changes -- deregulating current anti-group auto regulations and laws and giving consumers more no-fault insurance options. Senator Houston also cites the high number of risks still being ceded to CAR as a reason that competition would not be in the best interests of consumers this year. Finally, Senator Houston notes that reforms to CAR should be implemented prior to considering implementing any type of competition. Senator Houston concludes by stating that "under existing market conditions, without structural reforms, competition will be a disaster for consumers."

The SRB also opposes a return to competitive rating for the 1990 rate year. It states that there have been no changes in the market this year that would make it appropriate to depart from the fix-and-establish ratesetting procedure used last year. It points to several factors in the current market which would be impediments to to a well-functioning competitive system -- the size of the residual market and recent legislative changes and anticipated administrative changes. Due to the recent law changes, the SRB states that it would be difficult to ensure that consumers are adequately informed of price and service options and that insurers would have enough information this year to adequately price many coverages. The

SRB explains that Chapter 273 instituted a number of changes in deductible and coverage options that are new and therefore potentially confusing for consumers. It also notes that the Division of Insurance has announced that it is planning to implement a redesigned Safe Driver Insurance Plan. The SRB states that it will be not be possible to assure that rates for consumers just becoming familiar with direct pay programs, referral lists and new safe driver classes will not be excessive. The SRB also notes that the new programs being implemented under Chapter 273 will require a period of adjustment not only for consumers but for the industry as well. The SRB points out that insurers will not have enough data at this time to quantify the impact of the changes, and therefore it would be difficult to assure that rates for these coverages would be neither excessive nor so low as to pose a threat to company solvency.

The PIA and IIAM also advise against a return to competitive rating at this time due to the current market conditions. IIAM states that it believes that a pre-requisite for successful competition is an industry perception that rates are adequate and it does not believe that this perception can be assured in 1990. Both IIAM and PIA state that the reforms mandated by Chapter 273 and the changes that will be made to CAR must be implemented and evaluated prior to implementing competition.

This year, the AG once again recommends the limited introduction of competition. The AG testified about the ways in which the the current regulated system furthers inefficient company conduct and does not fully reward low-cost producers. He also states that the loss sharing mechanism used by CAR does not facilitate the cost-conscious settlement of claims. The AG states that the fix-and-establish system has not produced a stable, cost sensitive insurance market in Massachusetts. He states that premiums are exorbitant, cost controls are sorely lacking and insurers are withdrawing from the market. The AG emphasizes, as he has in the past, his belief that the costs of the current regulatory system are sufficiently high that a phased transition to a more competitive market is in the best interests of consumers.

As he did last year, the AG once again recommends that the Commissioner of Insurance institute flex-rating for the 1990 rate year for the optional property damage coverages -- collision and comprehensive. The AG notes that the optional property damage coverages are a sufficiently large percentage of premium (45% for people who purchase a full package of coverages) to create a sufficient incentive for comparison shopping. The AG notes that the special appeal of introducing competitive rates in these coverages is that these coverages have not exhibited the large, persistent, and unexplained increases in claim cost and claim frequency trends that have

beset the liability coverages. Therefore, it states that a realistic but narrow flex-rating band will fit these coverages well.

Under the AG's proposal, rates which fall within the flex-rating limits will be approved automatically and will be immediately effective. Rates beyond the flex-rating limits would require more extensive filings with actuarial support. He proposes that the Commissioner establish procedures for the review of filings beyond the flex limits. The flex rating limits would apply to individual class territory cells rather than the state-wide average rate. The AG stated that the flex limit should be tight enough to prevent excessive and disruptive rate changes, but loose enough to create options for consumers. Unlike last year when he recommended a flex range of plus or minus 10 percent from the then current rate levels for collision and comprehensive, this year the AG recommends that the Commissioner establish the range after seeking the views of interested parties at a subsequent hearing.

Under the AG's proposal, the Commissioner would still fix-and-establish rates for 1990 mandatory bodily injury and property damage coverages, establish classes and territories and continue to provide a long-term subsidy of the residual market to assure access to affordable insurance for clean-record drivers in high-rated territories.

The AG predicts that the results of the introduction of

workable competition to the automobile insurance market in Massachusetts are increased company efficiency, reduction in fraud and waste, and a reasonable balance in market entries and exits. The AG believes that CAR reform in conjunction with a competitive market will produce the most significant reduction in fraud and claims overpayments.

This year the MARB submitted a statement of its position on the issue of competitive rating and Richard J. Zeckhauser, a Professor of Political Economy at the John F. Kennedy School of Government, Harvard University testified on its behalf. The MARB states that it tends to agree with the AG that the long-run benefits resulting from properly-instituted competitive rating probably exceed the short-run costs of the transition to competitive rates. However, it points out that some very substantial issues need to be resolved prior to the implementation of competitive rating. It cites the following areas that need resolution: (1) reconciling competitive rating with efforts to reduce CAR's population and deficit; (2) reconciling competitive rating with the current requirement that ceded and voluntary risks be charged the same rate; (3) reconciling competitive rating with the territorial and classification systems; and (4) reconciling competitive rating with the SDIP plan. The industry further cautions that the earliest date that it believes that competitive rating should begin is July 1, 1990.

Professor Zeckhauser recommends that the Commissioner initiate a return to competitive rating on a timetable that allows the industry and consumers adequate time to make the transition. Professor Zeckhauser believes that all of the pre-conditions to vigorous and successful competition are in place in the Massachusetts private passenger automobile insurance industry -- a large number of independent firms operating on an efficient scale, the absence of customers captive to a single insurer, a product that is standardized so as to allow easy price comparison, and save regulatory barriers, low entry and exit costs. Professor Zeckhauser states that the recent company withdrawals from the Commonwealth are a serious and visible indicator that regulation is not working. He also points to the growth of the residual market as a sign that regulation of rates is not working.

Professor Zeckhauser, like the AG, does not advocate the complete deregulation of insurance rates. Although Professor Zeckhauser did not recommend a specific proposal for implementing limited competition, he lists what the important elements of successful transition to competitive rating would include: (1) a commitment from the Insurance Commissioner that competitive rating would begin on a specific date; (2) a phase-in of coverages subject to competitive rating, starting with optional coverages; (3) some constraints on changes in

coverages and rates in order to protect the current structure of relative rates; (4) a state-run consumer education and information program; and (5) reform of CAR to bring about a reduction of its population and deficit.

Professor Zeckhauser expects the following to result from competitive rating: lower rates as a result of greater efficiency within firms and a shift in market share to more efficient firms; more innovation; and a decrease in the net cost of automobile insurance (cost of company premiums and company losses less the value of insurance to consumers.) Finally, he states that competitive rating in conjunction with reform of CAR should help policymakers determine what are appropriate cross-subsidies.

The AIA also recommends moving towards competitive rating. It cautions that competitive rating must be implemented in a careful manner and in conjunction with reforms to CAR.

The CNA Insurance Companies ("CNA") are also in favor of competitive rating. CNA cites the benefits that consumers have received from competitive rating in its home state, Illinois. These include lower prices and a greater percentage of dollars returned to the marketplace by way of claims payments and dividends. CNA also recognizes that there is a need for an orderly transition. It recommends the use of flex-rating bands of plus or minus 7 percent for a statewide rate change and plus or minus 15 percent for any individual major class or

territory. Rates that are proposed which exceed the bands would require prior approval. CNA states that the process could begin with non-mandatory physical damage coverages for the first two years. After a five year transition period, it recommends phasing out flex-rating and implementing full open competition. CNA believes that open competition would reduce the size of the residual market and achieve a high degree of company commitment to the Massachusetts marketplace.

There is no dispute that consumers, agents and insurers are dissatisfied with the current automobile insurance system and all recognize the need for innovation and reform. Some significant reform efforts are already underway. As I mentioned earlier, the implementation of Chapter 273 is ongoing and the Division is in the process of developing proposals to reform CAR. The system is therefore currently in a state of flux and it is not yet clear what the impact of these recent and continuing reforms will be.

Strong arguments were presented this year in favor of introducing some form of limited competition as another way to address some of the problems that have been identified in the current system. However, as all of the witnesses cautioned, a return to any type of competition, even limited competition for optional coverages, would be a dramatic change to our system. The testimony cautions that we must learn from and avoid the mistakes of the unsuccessful experiment with competition in

1977 which resulted in excessive rate increases for high rated classes and territories. Therefore, competition, if it is to work, must be implemented at the right time and in a very careful and controlled manner. While the specific proposals in favor of limited competition are, for the most part, thoughtful ones which acknowledge the need for a careful transition from fixed rates to competitive rates, for the reasons explained below it would be premature to implement any type of competition within the next twelve months.

As was noted by many of the witnesses, including the MARB, there are a number of significant issues that need to be resolved prior to implementing competitive rating. The most significant is the need to develop a plan for reducing the size of the residual market. The testimony that asserts that competition itself will significantly reduce the size of CAR is not sufficiently persuasive. While insurer decisions about whether or not to cede a risk may be based, to some degree, on pricing, there are other factors, such as the CAR allocation rules which play a significant role in these decisions. As I noted earlier, in accordance with section 66 of Chapter 273, the Division is currently preparing a report for the Legislature which will contain proposals for CAR reforms. These reforms must be implemented by January 1990. The proposed reforms will have as their primary objective the reduction of the size of CAR. Therefore, since any proposal to

implement competition must contain some provision for pricing the rates for the risks ceded to CAR and must address the issue of the subsidy for the residual market, it makes sense to introduce structural changes to CAR aimed at reducing the size of the residual market before considering implementing any type of competition.

Another major problem with the proposals in favor of implementing competition is that they did not contain any concrete methods for dealing with the interrelationship between competitive rating and an appropriate subsidy and rate level for the risks ceded to CAR. I note that the pricing of the residual market risks was one of the factors that led to the end of the 1977 competitive rating experiment. Given that approximately two-thirds of the risks are currently ceded to CAR, which includes almost 100 percent of the state's urban risks, the rate level for CAR is an extremely significant component of any plan to return to competition which must be addressed and resolved in advance of implementing a return to competition.

Another factor which mitigates against a return to competition this year is that many reforms mandated by Chapter 273 have not yet been fully implemented, and I am not confident that insurers will have enough data about the impact of the Chapter 273 reforms to adequately price coverages, particularly the optional coverages, for 1990. Also, because these recent

reforms have inevitably resulted in some consumer confusion, it would be difficult, if not impossible, to get a system in place by January 1990 which would assure that consumers will have clear and sufficient information to also be able to make intelligent choices in a competitive market. Good consumer information is an essential element of a successful transition to competition.

The AG suggests that we address these issues by establishing a process this summer to solicit specific views of all interested parties on the technical issues arising from the introduction of flex-rating, including the interrelationship of CAR reform and competitive rating. While this is a good suggestion, the Division cannot begin such a process immediately because these issues cannot be adequately explored and resolved at this time, while the CAR reforms are being developed and prior to their implementation. There will not be sufficient time between the final CAR reform proposals and January 1990 to resolve these important and complex issues.

In summary, then, because the market is currently in a state of flux due to company withdrawals and ongoing reforms, for this year, I conclude that conditions in the marketplace do not provide assurances that there will be sufficient competition to assure that private passenger rates will not be excessive for 1990. Despite the appeal of the testimony in favor of implementing some form of limited competition in the

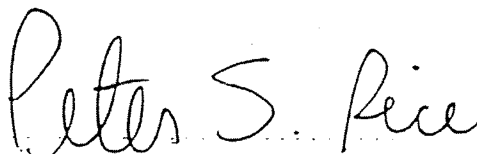
optional coverages, I find that the technical issues concerning the interrelationship of CAR reform to competitive rating must be more fully explored and the reforms of Chapter 273 more fully implemented prior to implementing any plan. Accordingly, I order that the procedures set forth in G.L. c. 175, § 113B, whereby the Commissioner fixes and establishes rates, will continue to be used for all coverages for the rate year commencing on January 1, 1990.

Having so ruled, however, it is clear that the possibility of introducing competition must be explored. Although the obstacles which preclude the introduction of competition this year are formidable, they should not be dismissed as insurmountable. Both Commissioner Singer and Timothy Gailey, Governor Dukakis' appointee to succeed Commissioner Singer this July, have expressed their commitment to trying develop a feasible and acceptable plan to implement some form of competition as soon as it is possible. Accordingly, the Division will seek to develop reforms to CAR which are compatible with a competitive market. Similarly, the Division will continue to implement Chapter 273 so as to pave the way toward a transition to competition.

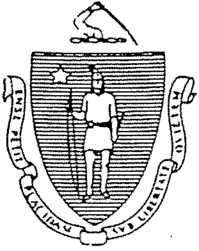
Moreover, while the AG's suggestion that we begin immediately to explore solutions to the problems hindering the introduction of competition cannot be adopted, we are committed to trying to develop workable solutions to these problems.

Therefore, I order that the hearing under G.L. c. 175E, §5, to determine whether the fix-and-establish ratesetting procedures used in 1990 should be used to set 1991 rates shall be conducted no later than January 31, 1990. This will ensure that there is enough time during the 1990 calendar year to develop a very careful and thoughtful proposal for implementing some type of phased-in competition by the 1991 rate year. We would be willing to consider phasing in competition as early as the latter part of the 1990 rate year if we could successfully implement a plan at that time.

This decision has been filed this twenty-eighth day of June 1989, in the office of the Commissioner of Insurance and with the Secretary of State as a public record. Any party aggrieved by this decision, may within twenty days, file a petition for review in the Supreme Judicial Court for the County of Suffolk.



Peter S. Rice
First Deputy Commissioner
of Insurance



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TIMOTHY H. GAILEY
COMMISSIONER OF INSURANCE

OPINION, FINDINGS AND DECISION ON THE OPERATION OF COMPETITION AMONG MOTOR VEHICLE INSURERS

Rendered July 26, 1990

Docket Number G-90-1

In accordance with G.L. c. 175E, s.5, a hearing notice was issued by the Division of Insurance ("the Division") on December 28, 1989 and Commissioner Timothy H. Gailey conducted a public hearing at 10:00 a.m. on January 23, 1990 to consider whether the fix-and-establish ratesetting procedure used to set 1990 private passenger automobile insurance rates should be renewed to set 1991 rates. A subsequent notice for a second day of hearing was issued on April 13, 1990, and Commissioner Gailey conducted a second day of public hearing on May 15, 1990. The record of the hearing was closed on that date. That record has been carefully reviewed in the preparation of this decision.

Under Section 5 of Chapter 175E, if the Commissioner of Insurance ("the Commissioner") determines, with respect to any territory or to any kind, subdivision or class of motor vehicle insurance, that competition is either i) insufficient to assure that rates will not be excessive, or ii) so conducted as to be destructive of competition or detrimental to the solvency of insurers, he shall fix and establish the rates for such insurance or territory pursuant to G.L. C. 175, s. 113B.

For the past 13 years the Commissioner has determined that competition has been insufficient to assure that insurance rates would not be excessive for private passenger automobile insurance. Each year the Commissioner has ordered that rates for the following year be fixed and established.

In 1988, for the first time in many years, there was renewed interest in the concept of a transition to a more competitive private passenger automobile insurance market. Commissioner Singer found a number of problems with the specific proposals that were introduced that year, in light of the conditions in the market at the time. Consequently, the Commissioner ordered that the fix and establish ratemaking procedure set forth in G.L. c. 175, s. 113B be continued for all coverages for calendar year 1989. However, the Commissioner did encourage the development of workable alternatives to the fix-and-establish procedure.

Last year, the hearing also generated considerable interest, and several new proposals to introduce some type of limited competition were presented. In his decision for 1990, First Deputy Commissioner Peter Rice ordered that the fix and establish ratemaking procedure be continued for all coverages for calendar year 1990. However, he ordered that the competition hearing for 1991 commence in January 1990, to allow a full exploration of the issues not only of whether to permit competition but also of the practical issues of how elements of competition could be reintroduced in Massachusetts in a controlled and successful way, and to have those issues resolved with sufficient lead time that if the Commissioner were to order competition for 1991, any delay in the hearing would not in itself render it impossible for competition to commence effective January 1, 1991.

This year, continuing with the intent of the 1990 decision, this hearing has addressed not only the issue of whether to return

to competition, but has also looked at very specific proposals and issues of the mechanics of how, when and in what areas to return to competition, if we do return to competition.

Formal testimony on competition was submitted by the Attorney General ("AG"), the State Rating Bureau ("SRB"), Senator John Houston, Commonwealth Automobile Reinsurers ("CAR"), the Automobile Insurers Bureau of Massachusetts ("AIB"), the Mayor's Office of Consumer Affairs and Licensing of the City of Boston, Massachusetts Citizen Action, the Massachusetts Public Interest Research Group ("MassPIRG"), Arbella Mutual Insurance Company, CNA Insurance Companies, The Hanover Insurance Company, Liberty Mutual Insurance Company, The Travelers Insurance Company, United States Fidelity & Guaranty Company, the Independent Insurance Agents of Massachusetts and the Professional Insurance Agents of New England.

This formal public hearing has been important to the development of a coherent and effective policy on competition, as well as to the resolution of the fundamental issue of whether the conditions for competition exist. However, a formal hearing does not lend itself readily to a fluid give and take of ideas, from a multitude of parties on the multitude of issues raised by the practical question of how competition might be returned to Massachusetts private passenger automobile insurance. In an effort to facilitate that discussion, the Commissioner formed an informal working group on competition, composed of a number of the parties which had appeared in the January hearing. That working group met initially on February 22, 1990, and two subgroups were formed to

discuss the somewhat separable issues of price competition and product competition. Those groups have met repeatedly, and are continuing to work on those issues. The Commissioner has requested that those groups continue to meet to address those issues independent of this hearing, and that the outcome of the work of those groups be available to the Commissioner, if appropriate, upon any reopening of this hearing in accordance with this decision, or in the competition hearing for 1992.

I. THE TESTIMONY PRESENTED

There was pervasive support for a return to some form of competition, and although there were differences in emphasis the concerns expressed as to the issues which needed to be addressed in controlling any such return were also nearly uniform. However, there was substantial disagreement as to when, how and the degree to which competition should be permitted.

Senator Houston opposed competition unless product competition were allowed first, so that consumers would be given new choices in insurance products. Such product competition could allow more innovation, and in his view would be more likely to benefit consumers than mere price deregulation. As to price competition, he urged as preconditions the effective implementation of the CAR depopulation plan, no "dirty rate" for the residual market, repeal of the insurance antitrust exemption, a continuation of the current discounts for safe drivers and of the cost containment efforts inherent in the current rate hearing, and improved consumer

information to allow consumers to make informed decisions as to new products and prices.

The SRB recommended that competitive rating continue to be suspended for 1991, citing the affirmative progress of the competition working group but the considerable unfinished work and unresolved issues that the group has faced. Generally, the SRB asserted a need to have several years of experience, after the 1988 reforms, to show the degree of rate stability necessary to give reasonable assurance that competition will result in little adverse rate change in the near future. Secondly, the CAR reforms put into place in 1990 will have profound impact on company and agency marketing strategies, creating substantial imponderables as to what competitive rating might result in.

The AG presented detailed proposals for a transition to price competition, but argued against implementation on January 1, 1991. The AG noted that many difficulties with implementing price competition remain to be worked out, and delaying implementation would give additional time to work out those details as well as avoiding the January 1 "bulge" in policy renewals which could make the transition to competition even more difficult. Delay until mid-year 1991 would also give more time to evaluate the effectiveness of CAR depopulation. He urged flex rating, limited in the first year to the property damage coverages because of their generally flat frequency and short "tail". He also cited the need for effective consumer information, including a proposal that price and claims-handling ratings for each company be provided to

consumers by a consumer information bureau to be established in the Division of Insurance or in the Executive Office of Consumer Affairs and Business Regulation. With respect to the rate subsidies inherent in rate flattening for urban and youthful drivers -- an issue which clearly must be addressed in any transition to price competition -- the AG urged the establishment of a rate subsidy system independent of CAR. He urged that with respect to any residual market rate the Commissioner should set the rate at or moderately above the average rate among the rates filed for the voluntary market.

The AIB took no position on whether to implement competitive rating in 1991, because there was disagreement among its members as to when to go to competition. It testified, however, that the majority favored competition as a long-term goal. It urged that nothing in the decision for 1991 preclude competition in 1992, and offered substantial assistance in examining the technical issues raised by the prospect of competition. Similarly, CAR took no position, but identified substantive issues relating to CAR's rules which would have to be addressed if there were a transition to competitive rating, and offered assistance in our deliberations.

Commissioner Diane Modica of the Office of Consumer Affairs and Licensing for the City of Boston argued that competition should not be implemented unless there was a repeal of the antitrust exemption, successful CAR depopulation, a fair system of subsidies for young and urban drivers, and adequate consumer education. She urged that allowing competition in 1991 would be premature.

MassPIRG testified that a more competitive environment could help lower rates and provide better consumer service. However, it argued that significant changes both in the insurance market and in the statutory framework need to occur before competitive rating could bring anything but market disruption and higher rates for consumers. It urged repeal of the antitrust exemption, modification or repeal of restrictive statutes governing group insurance and agent commissions, expansion of no-fault options and new products, enhanced consumer education, safeguards against discrimination, and CAR depopulation (and resolution of other CAR issues). Pending resolution of those issues, it asserted that competition in 1991 would be premature.

Similarly, Massachusetts Citizen Action argued for a move toward competition but felt that commencing competition in 1991 would be premature. It similarly commented on the early status of CAR depopulation, and the need for consumer information systems. It also argued that successful competition required market stability, which might be difficult in light of some companies' desires to leave the Massachusett auto insurance market and in light of the forthcoming change in administration. It raised concerns similar to those of other witnesses regarding subsidization and avoiding price shocks, and urged the repeal of the antitrust exemption.

Insurers presented a variety of positions on competition, although all were generally in favor of ultimately moving toward it. Arbella Mutual testified in favor of limiting competition to property coverages, with a system of flex rating similar to that

recommended by the AG and a number of other witnesses. It also recommended that the Commissioner continue to set territory and class relativities, and argued against a separate CAR rate.

CNA argued strongly for competitive rating starting in 1991. It urged the need for a transition plan starting with certain optional coverages in 1991, and expanding to include more coverages in the years thereafter. It also suggested the possibility of commencing competition on a territory by territory or other risk classification basis. It recommended gradually expanding flex rating. With respect to establishing a process for change, it suggested a joint industry/regulator group to manage the transition through the changes in administration, to provide continuity and stability. It urged the allowance of new, cost-based products and classifications. Finally, it suggested that competition would enhance the move to depopulate CAR.

Hanover Insurance Company also strongly urged a move toward competition. It argued for including all coverages and eliminating subsidies, but with a gradual phase in over a number of years.

Liberty Mutual Insurance Company endorsed the concept of competitive rating on a limited basis, relating to automobile damage coverages only, in a system of flex rating. It urged that the Commissioner continue to set territory and class relativities. In the area of consumer information, Liberty Mutual suggested that the Commissioner publish a quarterly comparison of rates filed by the various companies.

The Travelers testified in favor of reintroducing competitive rating as soon as possible, but felt that the preconditions necessary to do so could not be effected quickly enough for a January 1, 1991 implementation date, but felt with continued work a mid-1991 implementation schedule might be achieveable.

United States Fidelity and Guaranty Co. similarly favored competition within a flex rating system, recognized the need to work on the necessary preconditions, and suggested that if necessary competition could be adopted for the physical damage coverages only, as an initial phase.

The two agent associations, PIA of New England and the IIAM urged a controlled return to competition, reciting the same concerns over the residual market and relativities that most of the other witnesses alluded to.

II. DISCUSSION

Many of the witnesses saw competition, or potential competition, primarily as a return to price competition. Others, while addressing price competition, also saw the potential for another area of competition -- product competition, that is, allowing companies to offer consumers a choice of new types of insurance products as an alternative to the relatively inflexible standard Massachusetts automobile insurance policy. Product competition could result in more consumer choice, regardless of whether price competition on the basic Massachusetts auto policy were allowed.

Because price and product competition are not inextricably connected, and because they raise substantially different issues, I will discuss them separately.

A. Price Competition

Price competition has been the traditional subject of the competition hearing. It presents the most difficult issues, and it is one area where misjudgment could lead to a repetition of the 1977 failure in attempting a return to competition. However, price competition has the potential for promoting economic efficiency, stabilizing a troubled market and giving consumers the ability to shop for lower rates.

As was noted by many of the witnesses, there are at least three factors in the current market which are of particular significance in evaluating the possibility of price competition for 1991: 1) the size of the residual market and the results of the newly implemented residual market reforms; 2) the desire expressed by some companies to downsize their participation in or to withdraw from the Massachusetts auto insurance market generally, or the private passenger automobile insurance market in particular; and 3) the ongoing implementation of auto insurance reform legislation, Chapter 273 of the Acts of 1988 ("Chapter 273").

Almost all of the testimony discussed or alluded to the size of the residual market. As of year end 1989, approximately two-thirds of the private passenger automobile insurance risks were ceded to CAR. Although initial reports indicate an improvement in the cession rates for 1990, credible data is not yet available even

for the first quarter. However, it is essential that any proposal to introduce competition be examined and evaluated in relation to how it will effect the rates for the risks currently ceded to CAR, the proportion of risks ceded to CAR and the size of the deficit.

Testimony claiming that competition itself will significantly reduce the size of CAR is not persuasive. While insurer decisions about whether or not to cede a risk may be based, to some degree, on pricing, there are other factors such as the CAR allocation rules which play a significant role in these decisions. The experience with competitive rating in the commercial auto market shows that competition alone will not depopulate an otherwise troubled residual market.

This analysis is complicated by the fact that 1990 is the first year of a 4-year implementation period for significant revisions to CAR. A number of witnesses at the competition hearing discussed the relationship between the timing of CAR reforms and the implementation of any type of competition, and it is clear that this timing is crucial. At this date, inadequate information is available on CAR cession rates under the transitional rules, and at best such information relates only to the first few months of reform. While the changes appear to be positive, clear data is not yet available to indicate that CAR overpopulation has been reversed. I expect further and better data to be available in coming months, which may change the prospects of effective price competition. However, as the record now stands, I am unwilling to find the preconditions for price competition. The promise, hope

and, I believe, likelihood of positive change is not a sufficient basis for deciding on such a fundamentally important matter as a possible return to competition. As further data becomes available later in 1990, it may demonstrate sufficient positive movement to warrant a finding indicating the possibility of effective competition as early as July 1, 1991. As the record now stands, however, such a finding would not be supportable.

With respect to the willingness of insurers to act like true competitors in a price competitive system, there are still grave concerns as to some of the key insurers now in the market. While we have not seen the hemorrhaging of insurers from the market that we experienced two to three years ago, insurer withdrawal is still a major concern, and there are still indications that price competition may be viewed by some as a convenient mechanism for leaving a market that they would just as soon not be involved in nationally. In recent months, a number of national companies have publicly announced that, as a matter of their national corporate strategies, they would, or they would like to, withdraw from the private passenger auto insurance market, or to substantially reduce their writings in this area. This complicates the issue of competition, since a company which has as a major goal its own departure from a market is not likely to be or become an effective competitor in that market. The fact that many of these companies are withdrawing from private passenger auto in states with competitive rating does not give credence to those who suggest that if Massachusetts returns to competition those companies will decide

to stay. Free and open competition cannot work if potential competitors see any possible move toward competition as merely giving them more leeway to avoid servicing Massachusetts consumers.

On the other hand, a number of both national and regional companies have responsibly acted to improve the Massachusetts market, and have sought to bring elements of competition into this market because they wish to be allowed to compete. The possibility of a return to elements of competition in Massachusetts is without question one of the motivating factors in some of those companies' decisions not to withdraw or scale back.

However, as the record now stands, any plan to return to competition must deal with the problem of the "reluctant competitors". As with CAR depopulation and other issues, this factor could develop acceptably in the coming months, but as the evidence now stands, it is a factor which militates against implementation of price competition as of January 1, 1991.

Finally, Chapter 273, parts of which are still being or were recently implemented, introduced a number of significant changes to the automobile insurance system for consumers, the industry and the system at large. It changed coverage and deductible options and it required the implementation of new programs, such as pre-inspection and direct payment plans. The effects of most of these changes are showing up in the data for the first time this year, and to some extent the analysis of that data in connection with the 1991 rate hearing will be exceedingly helpful in determining whether price competition would be feasible. As with the evidence as to the

success of the CAR reforms, however, we are not yet at the point that there is clear evidence to suggest that price competition would adequately reflect the genuine savings from the 1988 reforms. Additional evidence and analysis will be available later in 1990 and in early 1991.

Another major problem with the proposals in favor of implementing competition is the lack of effective and concrete methods for dealing with the interrelationship between competitive rating and an appropriate subsidy and rate level for the risks ceded to CAR. The pricing of residual market risks was one of the factors that led to the end of the 1977 competitive rating experiment. Given that at least as of year-end 1989 approximately two-thirds of the risks were ceded to CAR, which included almost 100 percent of the state's urban risks, the rate level for CAR is an extremely significant component of any plan to return to competition which must be addressed and resolved in advance of implementing a return to competition.

It is my hope that the price competition advisory group will be able to work out a proposal to address those problems. The answer may be a phase-in of controlled price competition in connection with CAR depopulation milestones during the CAR reform transition, but we do not yet have that, or any other, answer worked out with any degree of confidence. Until those details and concerns are addressed with concrete analysis and regulatory, and if necessary statutory, mechanisms which would make it possible to transition to price competition, I am compelled to find that the

conditions for price competition do not exist sufficient to allow such competition at least as of January 1, 1991. However, in the event that the working group or other party or parties are able to develop a coherent, fair and defensible plan for an effective and fair transition to price competition commencing later in 1991, or in 1992, the parties may move to reopen this hearing for consideration of such a plan, as well as any new evidence available which may relate to the decision whether to implement a change to competition at such later date.

B. Product Competition

In section 35 of Chapter 273, the Legislature gave general direction to the Commissioner to consider new optional policy provisions to be introduced and offered to the Massachusetts automobile insurance consumer. That section states, in pertinent part:

> "In fixing and establishing classifications of risks, the commissioner may provide for appropriate reductions in the premium charges for the relevant coverages if he finds ... that any optional policy provision will result in savings through reduced costs."

Moreover, the basic law applicable to this hearing, G.L. ch. 175E, sec. 5, gives the Commissioner discretion in this hearing to make a separate determination as to competition with respect to specific coverages:

"If the commissioner determines, ... that, with respect to any territory or to any kind, subdivision or class of insurance, competition is either (i) insufficient to assure that rates will not

be excessive, or (ii) so conducted as to be destructive of competition or detrimental to the solvency of insurers, he shall [fix and establish the rates for such insurance or territory pursuant to G.L. C. 175, s. 113B]."[emphasis added].

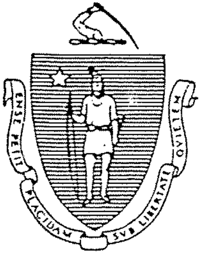
There are a number of insurance products offered in other states which might be attractive to Massachusetts consumers. Various members of the product competition subgroup enumerated a number of discounted policies which consumers in other states have the option to buy, new or different coverages not presently available in Massachusetts and new marketing approaches that might be approved. However, approval or nonapproval of such individual products or approaches cannot be made in the context of this competition hearing, because each such individual product raises issues independent of the competition issues and each would have to be evaluated in the context of an application for approval of a particular form of policy and rate structure. Simple discounts might be considered in a procedure analagous to the procedure for approval of a downward deviation. Other products would have to be subjected to considerably more scrutiny, to examine, with public input, their affect on consumers, the adequacy of the information to be given to consumers, CAR issues, fairness and nondiscrimination, rate issues and compliance with applicable law. Problems associated with limited staff resources to conduct such reviews and evaluations at the Division would have to be addressed to make product competition a practical approach as well.

However, while this decision can not approve or disapprove individual competitive products as such, nor resolve the problem of limited administrative resources, it can indicate a willingness to consider on their merits new competitive products or approaches as they may be developed and filed for approval. Any such filings would be subject to appropriate review on a case-by-case basis, with adequate public input and with the opportunity to impose conditions and safeguards to assure fairness, nondiscrimination, adequate consumer disclosures and information, appropriate treatment as to CAR, rate adequacy and other issues which individual products may raise.

III. FILING AND APPEAL

This decision has been filed this 26th day of July, 1990, in the office of the Commissioner of Insurance and with the Secretary of State as a public record. Any party aggrieved by this decision, may within twenty days, file a petition for review in the Supreme Judicial Court for the County of Suffolk.

Timothy H. Gailey
Commissioner of Insurance



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KAY DOUGHTY
COMMISSIONER

OPINION, FINDINGS & DECISION ON THE OPERATION OF COMPETITION AMONG MOTOR VEHICLE INSURERS

RENDERED August 20, 1991

Docket No. G91-16

On May 15, 1991, the Division of Insurance ("Division") issued notice of a public hearing to consider whether the fix-and-establish rate setting procedure followed to set 1991 private passenger automobile insurance rates should be renewed to set 1992 rates. On June 18, 1991, at 10:00 a.m., the Division held a public hearing on this subject, pursuant to the requirements of G.L. c. 175E, s. 5.

Under section 5 of c. 175E, if the Commissioner of Insurance ("Commissioner") determines, with respect to any territory or to any kind, subdivision or class of motor vehicle insurance, that competition is either i) insufficient to assure that rates will not be excessive, or ii) so conducted to be destructive of competition or detrimental to the solvency of insurers, she shall fix and establish the rates for such insurance or territory pursuant to G.L. c. 175, s. 113B.

History of Competition

In 1925, Massachusetts became the first state to adopt a compulsory motor vehicle liability insurance law. The law also required the Commissioner to fix rates for certain compulsory and related liability coverages. See, 72nd Annual Report of the Commissioner of Insurance, July 28, 1927.

Thereafter, automobile insurance rates were set annually by the Commissioner, whose authority to set these rates expanded to include substantially all coverages. This system was modified in 1975, with passage of a statute providing for

limited competition for optional coverages. St. 1975, c. 707, s.6. Shortly thereafter, in August of 1976, the Legislature enacted a competitive rating law which permitted insurers to file schedules of automobile insurance rates at any time. St. 1976, c. 266. The rates would be subject to approval by the Commissioner, who was required to disapprove a rate which was excessive or inadequate, or unfairly discriminatory. This profound change in the regulatory scheme was safeguarded by a provision which provided for a return to the earlier system, where rates would again be fixed and established by the Commissioner. Specifically, it provided that should the Commissioner determine that competition was either insufficient to assure that rates would not be excessive, or so conducted as to be destructive of competition or detrimental to the solvency of insurers, she should proceed to fix and establish the rates for a period of not more than one year, at which time competitive rating might be restored by the Commissioner upon appropriate findings of fact. Id.

In 1977, rates were filed under the competitive system. Commissioner James M. Stone's description of the results of this foray into competition reveal the extent of its failure.

> Although the average statewide increase in premiums was less than it had been the previous year, companies filed such widely differing relativities for the various territories and classes of drivers that some individual premiums for already high-rated groups rose by more than $1,000 from 1976 levels while rates for some low-rated groups went down. The burden fell most heavily upon the young and the urban.

> Percentage increases for many of these drivers were in the 50% to 100% range at a number of large insurers. Policyholders complained as never before. Calls to the Division of Insurance reached record levels. Angry mass meetings were held in several urban communities. The media treated automobile insurance as its major story of the season. Opinion, Findings and Decision on the Operation of Competition Among Motor Vehicle Insurers, June, 1978.

Commissioner Stone also noted that consumers complained not only about premium levels, but about difficulty finding price information, and about locating companies which would place their business. They also complained that many who tried to obtain the best price were relegated to the involuntary market, which at that time was permitted to charge higher rates. Id.

In June 1978, the Commissioner determined that competition was inadequate, citing the unavailability of pricing information, lack of competitive vigor by insurers, and an unreasonable pattern of Facility placements. In July, the Legislature enacted a rebate bill which provided for a 25 percent cap on 1977 premium increases, and a 10 percent additional discount for all drivers insured at Facility rates. Total customer rebates totalled approximately $50 million.

The Commissioner has determined each year since 1977 that competition has been insufficient to ensure that private passenger automobile insurance rates would not be excessive, and, accordingly has ordered that rates for the following year be fixed and established.

In recent years there has been renewed interest in introducing competition into the private passenger automobile insurance market. However, concerns about the size of the residual market, company withdrawals from the Massachusetts automobile insurance market generally, and the impact of automobile insurance reform legislation, St. 1988, c. 273 ("c. 273"), have thus far led Commissioners to reject a move to competition.

Last year, Commissioner Timothy H. Gailey found that those issues still prevented a return to competition. In an effort to address these and other concerns, however, he appointed a Working Group on Competitive Rating ("Working Group") to consider the issues related to potential implementation of competitive rating. The Working Group, formed in February 1990, includes representatives of the Alliance of American Insurers, the American Insurance Association ("AIA"), the State Rating Bureau ("SRB"), the Massachusetts Attorney General ("AG"), the Massachusetts Public Interest Research Group ("MassPIRG"), Massachusetts Citizen Action, the Boston Mayor's Office of Consumer Affairs and Licensing, Arbella Mutual Insurance Company ("Arbella"), Liberty Mutual Insurance Company ("Liberty Mutual"), the Travelers Insurance Company ("Travelers"), the Independent Insurance Agents of Massachusetts ("IIAM"), the Professional Insurance Agents of New England ("PIA"), the Massachusetts Auto Insurance Agents Association, and other interested parties.

The Working Group issued a report in December, 1990, which has been made a part of the record in this hearing and which is discussed further below.

The critical issue to be addressed, therefore, is whether current market conditions would allow a return to competition. Assuming favorable market conditions, the second issue for consideration is the type of plan which would allow a return to competition to be successful. Testimony was offered this year from a number of witnesses with respect to the competitive environment at this time, as well as anticipated changes in the near future. The testimony we received was virtually unanimous that the market conditions disfavored a return to competition in 1992. The majority of these witnesses spoke, as well, to the question of whether the proposal put forth by the Working Group would constitute a plan which could achieve a measure of success.

Summary of Evidence Presented Regarding Competitive Rating in Policy Year 1992

- Consumer representatives who testified included Steven Pizer, Executive Director of Massachusetts Citizen Action; Josh Kratka, attorney for MassPIRG; Hilary Rowen, Special Counsel for Regulatory Issues to Attorney General Scott Harshbarger; and Diane J. Modica, Commissioner of the Mayor's Office of Consumer Affairs and Licensing in Boston. Their testimony indicated that they supported competition in principle, and were persuaded that competitive rating could provide tangible consumer benefits. They all cautioned, however, that the Commissioner should be cognizant of the complexity of making such a move, and recognize the needs of consumers. They repeatedly noted that current regulations do provide important protections to consumers, and those protections should not be abandoned. They also agreed that price fixing must be prevented, or consumers would not see the benefits of deregulated rates. Further, they opposed an immediate move to competition, concluding for a number of reasons that it would be premature.

The greatest obstacle to competitive rating, they agreed, was the disproportionate number of exposures ceded to the Commonwealth Automobile Reinsurers ("CAR"). Mr. Pizer stated that in 1990 roughly half of the market was ceded to CAR, which is an indication that the insurance industry does not wish to voluntarily write private passenger automobile insurance. He surmised that competition would be harmful for that less

attractive half of the market, and feared that deregulation would touch off a race to raise those rates the fastest and drive away the unwanted business as happened in 1977. Both Mr. Pizer and Mr. Kratka noted that the utilization formula for allocating the CAR deficit has not been fully phased in, and Mr. Kratka asserted that a move to competitive rates at this time may lead companies to raise rates in order to reduce their market share. They joined in arguing that we need to see sustained depopulation of CAR prior to implementing competitive rating. Additionally, Mr. Kratka stated that the large number of exclusive representative producers ("ERP's") would create insurmountable fairness and implementation problems at this time.

The AG agreed that the transition to competition should be gradual, and acknowledged that there is general consensus that a year's lead time is necessary. Nevertheless, the AG recommended that the Commissioner consider introducing flex rating for policies issued after July 1, 1992. The AG cited recent, although incomplete, data on the first quarter 1991 CAR cession rates, to argue that the size of the residual market is decreasing.

Speaking on behalf of insurance agents were Daniel J. Foley, Director of Government Affairs and General Counsel for PIA; Edward Donahue, Director of Government Affairs for IIAM; and Robert J. Firnstein, an independent agent from Hopkinton.

Together, they urged that rates be fixed and established for 1992, stating that current market conditions do not warrant a move to competitive rating.

Mr. Foley, as had others, opposed a move to competitive rating until implementation of c. 273 is complete. Mr. Donahue joined in this sentiment, doubting whether the structure of the current residual market is appropriate for competitive rating, and warning of the potentially disastrous impact of a badly implemented move to competition on policyholders and the Massachusetts automobile insurance system. Citing a lack of insurer confidence in the Massachusetts market, evidenced by the unwillingness of many companies to write new business and the continued withdrawal of companies from the market, Donahue and Firnstein questioned whether the industry would solicit business aggressively in the majority of classes and territories. If not, Mr. Donahue asserted, competition would lead to rapid rate escalation. Mr. Donahue also questioned whether compliance with the spirit of statutory anti-discrimination measures could be assured in a competitive environment.

Industry representatives were united in favoring competitive rating, but, as well, urged caution in implementing any system of competition.

Thomas E. Cremin of the Domestic Automobile Insurers of Massachusetts ("DAIM"), and Joseph D. DiGiovanni, of the AIA, testified in support of competitive rating. Both agreed,

however, that a 1992 timetable for initiating competition would be unrealistic. Mr. Cremin stated that no specific plan, including the "working group" proposal, is ready for implementation, and additional study and discussion to develop a workable plan are in order. Noting that automobile insurance is compulsory, he cautioned that public policy must be sensitive to issues of affordability and availability. Mr. DiGiovanni suggested that the Commissioner develop a timetable for the implementation of competition. Commenting on concerns expressed earlier regarding possible price-fixing under a competitive system, DiGiovanni asserted that current statutory anti-trust provisions are adequate, and suggested that additional regulations issued pursuant to c. 175E, s. 6 should suffice to allay any such concerns.

Thomas J. Driscoll, Legislative Counsel for Liberty Mutual, and Edwin J. Rinehimer, Regional Vice President of the Travelers, testified in favor of a return to competitive rating. Richard W. Brewer, Chief Executive Officer of Arbella, and Senior Counsel David R. Anderson of the CNA Insurance Companies ("CNA") submitted written statements in which they, likewise, supported competitive rating. Noting that Massachusetts automobile insurance rates have been set by the state in all but one year of the last sixty-five, Mr. Driscoll argued that this strict regulation has not insulated Massachusetts drivers from the financial strain of high auto insurance rates. He stated that insurance companies strive to

differentiate themselves by competing in product, service and price, and that the fix-and-establish rating system homogenizes the market, making it more difficult for a company to establish a singular identity. He stated that insurers fear the impact of political pressure on this type of rating system, and that in the past those fears have been realized.

Mr. Driscoll, Mr. Rinehimer and Mr. Brewer, however, agreed that strategic impediments existed to a move to competition in 1992. Mr. Rinehimer cited the CAR deficit, currently in excess of four hundred million dollars, as the principal impediment. He stated that this deficit is borne inequitably by various insurers in Massachusetts due to the operation of Rule 11. Until the new utilization formula fully replaces Rule 11 as the deficit sharing mechanism, he stated, competitive rating could not become a reality. Mr. Rinehimer and Mr. Anderson also emphasized that competitive rating would only succeed if it starts from adequate fixed-and-established rates. Mr. Brewer cautioned, as well, that a hasty move to competition would create distortions and disruptions, and might cause the rejection of further attempts to implement competition.

Discussion

This year's testimony showed a remarkable consensus of opinion about moving to competitive automobile insurance pricing. Rather than the markedly divergent views which have been proffered in the past, representatives of consumer groups, the insurance industry, and agents' associations all foresaw benefits to the public and the industry from competitive rating. As Mr. Driscoll noted, regulation has homogenized the market. As companies seek to distinguish themselves in a competitive market, consumers should benefit from lower rates, an increased number of product options, and improved service.

As virtually all witnesses pointed out, however, present market conditions disfavor an immediate move to competition. Concerns raised at last year's hearing were heard again: doubts as to industry interest in competing for private passenger automobile insurance business, the size of the CAR deficit, and the not yet fully implemented c. 273 changes.

Consumer advocates and agents expressed concern about whether companies indeed wished to compete for Massachusetts private passenger automobile insurance business. Their concern parallels that expressed by the companies: unless rates are adequate, there will be no competition.

The number of risks currently ceded to CAR, and the size of its deficit provide evidence of the companies' unwillingness to voluntarily write private passenger business under present market conditions. In the past, companies have argued that

inadequate rates were the primary cause of high cession rates. However, despite rate increases and c. 273 CAR reforms, which have been even more successful than anticipated in depopulating CAR, CAR still underwrote slightly less than half of the private passenger risks in policy year 1990.

The AG alone expressed confidence that the steps taken to reduce CAR and its deficit have had such an immediate impact that the problem has been adequately addressed. While the initial data show heartening progress, cession rates in 1989 were 68 percent, in 1990, 45.2 percent, and the projected cession rate for 1991 is 30 percent. Further, initial efforts to depopulate CAR have not led to a comparable reduction in the deficit, as the better risks are generally removed first during the depopulation process. The CAR deficit for 1990 is currently estimated to be approximately $420 to $450 million. Therefore, while the initial data show that CAR rule changes are having a favorable impact, and we anticipate that there will be a positive ongoing impact of CAR reform, both the size of the deficit and the cession rate remain significant, and must be addressed before competition can be implemented.

The only fair conclusion which can be reached is that competition, at this time, is insufficient to ensure that rates will not be excessive, or that it would be conducted so as to be destructive of competition or detrimental to the solvency of insurers.

Nevertheless, there have been a number of positive changes in the private passenger market over the past few years which may be conducive to successfully introducing competition in Massachusetts in the near future. The residual market is showing real signs of improvement as a result of c. 273 reforms, and companies have ceased abruptly pulling out of the market. A period of market stability should alleviate remaining concerns.

The opportunity before us now should not be lost. With careful planning and diligent effort, it will be possible to prepare the way for the implementation of competitive rating in the near future. Much of the groundwork for such a plan has been done by the members of the Working Group. A substantial portion of the testimony presented at the hearing focused on that plan, and it warrants discussion here.

<u>The Working Group Proposal</u>

Briefly, the Working Group, in its December 1990 report, presented six goals for competitive rating: to attain more efficient regulation by competition for the maximum number of risks; to achieve adequate pricing for as many risks as possible; to enhance the viability of the voluntary market for all classes and territories; to encourage efficiencies among insurers and reduced costs to consumers; to provide consumers with choices with respect to price, service and products; and to facilitate the reconstitution of CAR as a true residual market.

The Working Group identified several components of a competitive rating system which would be required for the program to be successful and to meet the established goals. First, it determined that rates must be set competitively for most rating classes and territories. Secondly, it concluded that the rate tempering and flattening, and other price protections present in the current structure, must be continued, at least in the short term, in order to avoid substantial rate increases for individual insureds. Next, it concluded that pricing and other information should be made readily available to consumers, and that a comprehensive market review mechanism be established to detect anti-competitive behavior among insurers. The Working Group believed also that transition provisions should be in place to prevent large premium increases in the competitively rated areas, but also to

allow for sufficient pricing flexibility. Finally, the Working Group recommended that the current statistical plan data collection be continued, to allow for use of such data in market conduct reviews and to preserve the ability to return to a fix and establish rating approach if competition were to fail to perform as hoped.

The proposal developed by the Working Group provides for the continuation of a fix-and-establish rating system for those rating classes and territories that would be likely to receive large rate level increases if deregulated. Those territories should be limited, comprising no more than 20 percent of statewide exposures. These particular territories or areas would be determined after a hearing set to coincide with the biennial territorial assignment hearing.

Rates for all other areas would be on a "file and use" rating system. Limitations would be placed on the rate changes allowed in these areas, and the Working Group recommends that flex bands be used for this purpose.

Companies writing risks in the fix-and-establish areas would be provided with a "secondary" premium that would compensate for the difference between the maximum allowable rate for those risks and the indicated rate. This secondary premium would be funded by an assessment on all private passenger insurers, with the amount to be determined either as a percentage of premium or a dollar amount per exposure. The Working Group envisioned that CAR might act as the transfer mechanism.

Certain rating factors, such as the Safe Driver Insurance Plan, passive restraint discounts, multi-car discounts, anti-theft discounts, T-pass discounts, high-theft vehicle surcharges, senior citizen discounts, and low mileage discounts would be retained, and would be fixed by the Commissioner and offered by all companies.

Companies would continue to be required to provide the same statistical reporting details. Additionally, they would be required to provide market conduct data such as rating examples and profiles of insureds by class and territory.

A toll-free telephone service would be established in order to provide consumers with accurate, current information regarding companies' rates, rating plans, complaint ratios, coverage options, limits, solvency ratings, and other information.

In considering the transition to competition, the Working Group suggested that, initially, rates in competitive territories be contained within flex bands. Those bands would set maximum percentage increases, both overall and for individual cells, based on each company's prior year's rates, for each company's statewide average rate. Two years after the introduction of competitive rating under this plan, those restrictions would be removed.

Unresolved issues identified by the Working Group include the current Rule 12 credits, the role of CAR under competition, and the additional responsibilities the introduction of

competition would impose on the Commissioner of Insurance and other state agencies.

The Working Group concluded its report by stating that it believes that the Commissioner has the authority to accomplish the key elements of the competitive rating approach described in its report.

Summary of Testimony Presented on Working Group Proposal

Chief Counsel Stephen D'Amato of the SRB reported on the activities of the Working Group since its inception, and noted that the group, as reported in December, 1990, reached general agreement on the ultimate issue of competitive rating, the general structure of a competitive approach, and the details of a competitive rating structure which it could endorse.

The AG, Mr. Kratka of MassPIRG, Mr. Pizer of Massachusetts Citizen Action, and Ms. Modica of the Boston Mayor's Office of Consumer Affairs and Licensing, all emphasized the importance of the continuation of safeguards for consumers against large or unjustified rate increases, and the prevention of unfair discrimination in rates and coverages. To that end, they supported the Working Group recommendation to bifurcate the introduction of competition, opening up competitive rating first in those territories and for those classes of drivers for whom rates are already within a reasonable range of the actuarially indicated rates, while in other territories and classes rates would continue to be set.

This, in the AG's opinion, would avoid the 1977 experience, when rates for inexperienced urban drivers rose precipitously. As the proposal, however, did not determine where to draw the line between the two sets, the AG urges that this issue be given careful consideration.

Similarly, the Working Group proposal did not address the precise range of the flex bands set to limit rate changes within the territories in which competition is being introduced. The AG recommends that the selection of the range be consistent with the delineation of the class-territory cells.

The AG next noted the proposal to create a mechanism to supplement the subsidized rates in the high-rated cells. He opined that this would provide better incentives for companies to avoid unnecessary cessions than would the current CAR Rule 12 mechanism, but cautioned that the mechanism and its interaction with Rule 12 needs refinement.

The consumer information system included in the Working Group proposal was also praised by these witnesses. The AG asserted that the present agency system could not adequately apprise consumers of their choices in a competitive market, as most agents work for only a few companies. Both Mr. Pizer and the AG stated that a central source of information for consumers is necessary, and recommended that work begin on the design of a comprehensive consumer information system. Mr. Pizer urged that this be fully in place before any attempt is made to

deregulate rates. Further, they expressed concerns regarding the potential for price fixing, and the AG recommended that the Commissioner issue regulations proscribing anti-competitive behavior by companies and agents.

Mr. Kratka also commented favorably on the proposal's recommendation to continue the existing Safe Driver Insurance Plan, and the system of discounts. This, he testified, will guarantee minimum levels of fairness and incentives for risk-reducing behavior by consumers.

As the SRB reported, the Working Group left some issues open for later consideration. In order to resolve those issues and determine an appropriate timetable for implementing competition, the SRB, MassPIRG, Citizen's Action, and the AG support the proposal that an implementation group be established. The purpose of that group would be to evaluate the timing of the introduction of competitive rating, the length of the phase-in period and the size of the flex bands to be used during that period, the definition of the class/territory cells open to competition, as well as the other unresolved transition issues identified in the Working Group's report.

The two agents groups, IIAM and PIA, although represented on the Working Group, nevertheless voiced concerns regarding the details of the competitive rating approach. The agents referred to the issues raised by the AIB in its analyses of the proposal, particularly, how a competitive rating system will affect CAR in its operations in relations to agents, legal

issues regarding the proposed consumer information hotline, and compliance with the provisions of current competitive rating law c. 175E. They urged that only licensed agents should provide information to consumers on rates and coverage options. Both urged that any plan to implement competitive rating be carefully considered, and Daniel Foley offered the assistance of PIA in developing such a plan.

The AIB filed two reports analyzing the proposal put forth by the Working Group. The first, the "AIB Summary and Analysis," discusses actuarial, financial, and operational issues raised by the proposal. The second, entitled "Legal and Regulatory Issues Raised by the Working Group on Competitive Rating and Automobile Insurance: Analysis of Competitive Rating Approaches," identifies six potential legal issues for consideration prior to the implementation of the Working Group competition proposal.

Those who had served on the group on behalf of insurers also offered assessments of the Working Group's proposal. Mr. Driscoll, of Liberty Mutual, spoke of the need to avoid the negative experience of 1977. He stated that that movement to full competition failed to consider the impact of a long history of rate flattening and subsidization across the state, and that consumers were unprepared for a movement to cost-based pricing. The Working Group proposal, he stated, includes several provisions which provide the safeguards missing in 1977. Initially, he stated, subsidization of certain classes

and territories should be continued to avoid rapid movement by class and territory. Secondly, he believed that competing across all coverages would provide the most flexibility in pricing and permit insurers to counterbalance unusual variations in experience for one coverage with stability in others. Mr. Driscoll also supported the application of reasonable flex bands to individual company rate changes, stating that those should be permitted on a file-and-use basis, while increases or decreases outside of the band should be subject to prior approval.

Mr. Driscoll cautioned that the Working Group proposal is not true competitive rating, but instead a framework which attempts to deal with the flaws of the 1977 attempt to introduce competition, and to give insurers additional control. He noted that a number of questions remain unanswered in the Working Group proposal, and voiced Liberty's willingness to continue to participate in resolving these issues.

Mr. Rinehimer, of the Travelers, lauded the progress made by the Working Group in developing a framework for a competitive rating system. He, as well, stressed that substantial work remained to be done. First, he recommended that the Working Group proposal be made available to a broader audience for comments and questions, and that the Working Group have an opportunity to consider those comments. Next, he recommended that the Commissioner appoint an implementation group, which would include representatives of CAR, the AIB,

policy issuance systems vendors and small and large insurers. Finally, he recommended that the Commissioner set a date certain in 1993 for implementation of competition.

Mr. Brewer of Arbella wrote to support the Working Group proposal. Noting the difficulty inherent in any move to competition, he cautioned that such an undertaking be thoughtful, reasoned, and carefully planned. He noted that the framework established by the proposal retains many of the desirable features of the fix-and-establish system while allowing for a significant amount of competition.

CNA alone opposed the Working Group proposal, and wrote to offer its own. Mr. Anderson listed several objections, contending, first, that a dual system of competitive and fixed and established rates would add additional expense to the rate-setting process, particularly the increased cost to the Division of reviewing numerous filings. Secondly, he called "unrealistic" the expectation that companies will reduce rates on overpriced risks without first obtaining relief on subsidized rates. CNA proposes that competition be introduced in the context of cost-based pricing, and that there be a transition period for the introduction of competition. During that transition the optional coverages would first be subject to competition, and then, perhaps, flex bands would be introduced for a three year period.

Conclusion

The Working Group has done a commendable job, not only in developing a framework for implementing competition, but also in generating a consensus among participants with very divergent interests. The final report, however, admittedly left unresolved a number of issues, which must be addressed before competition can be implemented.

All of the testimony supports adopting the final recommendation of the Working Group, that an implementation committee be appointed. That committee should use as its framework the proposal developed by the Working Group, and with that begin to resolve the technical questions raised by both the Working Group proposal and the analyses of that proposal which have been offered to date. It will be necessary to include individuals with the technical expertise to resolve the many issues which have been identified, and to address any additional issues which may arise during the course of developing a final plan.

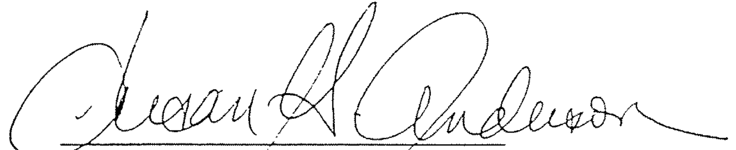
We anticipate that the job of the Working Group is not yet done, as resolution of the remaining issues by the implementation committee may warrant revisiting portions of the original Working Group proposal. The service which this group could provide, were its members to continue in an advisory capacity to the implementation committee, would be extremely valuable.

Our present opportunity to develop a competitive rating system should not be wasted. Timely, deliberate action will provide the means to resolve the remaining issues which prevent movement to competition in 1992 and to finalize a plan for doing so. The implementation committee should target 1993 as the date for implementation of a competitive rating approach. We must also heed the admonitions voiced in this hearing that any plan be carefully and thoroughly considered.

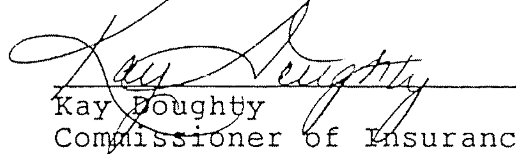
The timing for the implementation of a competitive rating system must also proceed in concert with the resolution of the problems which have plagued the residual market. As virtually every witness testified, the cession rate to CAR and the size of the CAR deficit continue to be major impediments to the implementation of any plan for competitive rating. We note as well that the reallocation of the CAR deficit, the phase-in to a utilization formula, will not be complete until 1993. It is of critical importance that that process be completed.

In conclusion, we reiterate that conditions in the marketplace do not provide assurances that insurers will compete sufficiently so that private passenger class rates will not be excessive for 1992. Therefore, with respect to the private passenger class, the procedures set forth in G.L. c. 175, s. 113B, whereby the Commissioner fixes and establishes rates, will continue to be used for all coverages for calendar year 1992.

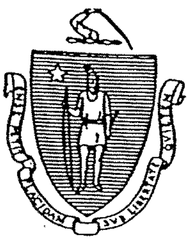
This decision has been filed on this twentieth day of August, 1991, in the office of the Commissioner of Insurance and with the Secretary of State as a public record. Any party aggrieved by this decision may, within twenty days, file a petition for review in the Supreme Judicial Court for the County of Suffolk.



Susan G. Anderson
Chief Hearing Officer



Kay Doughty
Commissioner of Insurance



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June 25, 2002

Julianne Bowler
Commissioner of Insurance
Division of Insurance
One South Station
Boston, MA 02110

Dear Commissioner Bowler:

I write on a matter of importance to Massachusetts consumers and to insurers writing private passenger automobile insurance in Massachusetts. In connection with a study of the automobile insurance market, my staff and I have examined the functioning of the residual market in Massachusetts, Commonwealth Automobile Reinsurers or "CAR." Based on our examination of the available information, including statistical data provided by CAR itself, we believe that the CAR plan for providing access to insurance in the residual market does not comply with the CAR enabling statute, and must be changed to produce a fair and equitable market. I now write to share findings with you and to propose that we work together to develop an equitable result for policyholders and insurers in the residual market.

Commonwealth Automobile Insurers. As you know, CAR provides access to automobile insurance to Massachusetts drivers who are not able to obtain automobile coverage through the voluntary market. *See* G. L. c. 175, § 113H ("[i]nsurance companies undertaking to issue motor vehicle liability policies or bonds... shall cooperate in the preparation and submission of a plan which shall provide motor vehicle insurance to applicants who have been unable to obtain insurance through the method by which insurance is voluntarily made available...."). CAR's enabling statute does not lay out the "plan" to provide insurance in the residual market; that system is contained in the CAR rules. The statute simply mandates that "[s]uch a plan shall provide for the fair and equitable apportionment among such insurance companies of premiums, losses or expenses, or any combination thereof."

Under the CAR Rules, CAR assigns agents located in cities and towns that theoretically are underserved to individual carriers in Massachusetts. Those agents are known as "exclusive representative producers" or ERPs (the exclusivity is not required by statute, which provides that

ERPs must be assigned to at least one servicing carrier, and is generally inconsistent with the structure of the voluntary market, in which independent agents typically have contracts with two or more insurers). While ERPs do not write high risk insurance in the traditional residual market sense of insurance for customers who are unable to obtain insurance in the voluntary market, most ERPs are located in subsidized territories in which premiums are inadequate to cover losses and expenses. In 2000, approximately one million private passenger automobile insurance policies, about 25% of the market, were written through ERPs.

In order to examine the functioning of the residual market, we met with, and had discussions with, several insurance carriers to get their views on the CAR plan. In addition, we obtained and analyzed statistical data from CAR. As I will explain, the data show unequivocally that losses are not fairly and equitably apportioned among the companies. Consumers currently have a choice of 22 companies writing private passenger automobile insurance in Massachusetts, a small number by national standards. As a result of insolvencies, acquisitions, and departures from Massachusetts, this number has shrunk by 20% in the past couple of years. The shrinkage of the market is expensive and disruptive for policyholders, reduces choices for consumers, and may increase the risks for the remaining companies. It is not unreasonable to believe that the inequitable apportionment of ERP losses may contribute to both future insolvencies and/or additional market shrinkage.

ERP Loss Ratios. An examination of ERP loss ratios among the companies shows most clearly the unfair and inequitable apportionment of losses. *See* Table 1. For the five year period 1996-2000, the (weighted) average ERP loss ratio for all companies in Massachusetts was 104%. The variance among companies, however, was startling – some companies had ERPs with loss ratios of 75% while other companies had ERPs with loss ratios as high as 200%.

Of the ten companies with the worst ERP loss ratios during this period (greater than 114%), two became insolvent, three were acquired by other insurers or departed from Massachusetts, one acquired a departing insurer's business, and one recently closed down its voluntary agencies in Massachusetts. Arbella, the second largest writer in Massachusetts during this period, was just downgraded by A.M. Best, which publicly blamed the downgrading on Arbella's CAR experience. Two others, State Farm, the largest writer nationally, and USAA, the seventh largest nationally, have not actively marketed insurance in Massachusetts. Based on our discussions with individual companies, many companies have reduced their market share or refrained from competing to increase their market share in Massachusetts because of the inequitable sharing of CAR losses.

ERP Losses. Data from the 1996-2000 period on ERP losses within the companies tell a similar story. *See* Table 2. Losses attributable to a company's assigned ERPs varied from 27% of total losses to 69% of total losses. Horace Mann, which recently announced that it was

leaving Massachusetts, had 69% of its losses come from its ERPs. (The loss ratio of the ERPs assigned to Horace Mann was 200%.) For seven companies, ERP losses represented over 50% of their losses during this period.

We are aware of the view that companies can manage, if not control, high losses by changing their claims practices. We do not believe, however, that companies' claims practices, *i.e.*, their ability to control claims costs, are responsible for the wide variation in ERP losses. Companies have told us that in processing claims, they do not make a distinction between ERP and voluntary business, and that they process all claims in the same manner using the same methods and techniques. Comparing the companies' voluntary loss ratios with their ERP loss ratios shows a much narrower range of variation – during the 1996-2000 period, the companies' voluntary loss ratios varied from 39% to 71%. (Again, ERP loss ratios varied between 75% and 200%.) *See* Table 3. The standard deviation of voluntary loss ratios was 7%; the standard deviation of ERP loss rations was 30%. Some of the companies with the worst ERP loss ratios had low voluntary loss ratios. Of the ten companies with the worst ERP loss ratios during the period, five had voluntary loss ratios that were among the ten best in the market, including Horace Mann, which had the worst ERP loss ratio.

Distribution of ERPs. It appears that the inequitable apportionment of losses is not a reflection of claims practices, but results from the assignment of ERP agencies to individual companies, which then "own" the agencies' losses. During 2000, for example, ERP loss ratios varied from very good (less than 20%) to spectacularly bad (greater than 400%). *See* Table 4. The distribution of the low loss ("good") ERPs and high loss ("bad") ERPs among the companies also varied widely. These numbers clearly show that some companies have almost all good ERPs while other companies have almost all bad ERPs.

During 2000, for example, some companies had no ERP losses from ERPs with loss ratios of less that 80% ("good" ERPs), while other companies had as much as 69% of their ERP losses come "good" ERPs. *See* Table 5 (nine companies had fewer than 10% of their losses come from good ERPs; eight companies had over 40% of their losses come from good ERPs). At the other end of the spectrum, the percent of company ERP losses from agencies with loss ratios over 160% ("bad" ERPs) varied from 0 to 91%, i.e., some companies had no ERP losses from "bad" ERPs while others had 91% of their losses come from "bad" ERPs . *See* Table 6 (nine companies had 1% or less of their losses come from bad ERPs while nine had 30% or more of their losses come from bad ERPs). Overall, seven companies have mostly "good" ERPs (deriving less than 10% of their ERP losses from "bad" ERPs and more than 30% of their losses from "good" ERPs); seven other companies have mostly "bad" ERPs (deriving more than 30% of their ERP losses from "bad" ERPs and less than 10% of their losses from "good" ERPs).

Financial Consequences of Inequitable Distribution of ERP Losses. The inequitable distribution of ERP losses in Massachusetts has resulted in the insolvency of companies, departures from the state, and an erosion of the surplus and financial weakness of some companies. We examined the impact of the inequity in the current distribution of ERP losses on companies' net income and surplus. Table 7 shows the results of a comparison between the current system and a hypothetical system that distributes ERP losses in proportion to a company's voluntary market share. As you can see, some companies have benefited substantially from the inequitable distribution, one by nearly $170 million, while others have been significantly disadvantaged, seeing their surplus erode by as much as $51 million. For many companies, then, ERP losses are the single most important factor in profitability – ERP exposures represent (on average) about a quarter of a company's exposures and the variation in voluntary loss ratios is relatively small.

Corporate Behavior. In addition to the insolvencies, departures from Massachusetts, eroded surplus and financial weakness of some of the companies, the inequitable distribution of ERP losses has had the effect of stimulating uneconomic behavior among the companies. According to Hanover, for example, Arbella last year allegedly paid over a million dollars to one of Hanover's ERPs to finance that ERP's purchase of Arbella ERPs with poor loss ratios; those ERPs – and their poor loss ratios – then became Hanover ERPs. (The Division of Insurance recently dismissed Hanover's administrative complaint; Hanover's appeal of CAR's decision refusing to stay the operation of CAR Rule 14 was dismissed by the Chief Hearing Officer, acting on behalf of the Commissioner, and Hanover's subsequent request for a preliminary injunction was denied by the Superior Court.)

Similarly, deals between insurers and ERP agencies affiliated with other insurers, which involve the transfer of substantial cash payments from the companies to the agencies, are common. When companies have more than 110% of their "ought-to-have" share of ERP exposures, CAR rules invite the other companies to contract with the over-subscribed company's ERPs through two-party deals. This procedure often has the effect of further increasing the inequitable distribution of losses. Since CAR publishes the loss ratios of all of the ERPs assigned to the over-subscribed company, the other companies generally take the low-loss ERPs from the over-subscribed company – a company with too many ERP exposures often then finds that it has lost its low-loss ERPs, and remains with a disproportionate share of high-loss ERPs. Companies have told us that to assure that their "good" ERPs remain affiliated with their company, they make payments to low-loss ERPs to prevent poaching by other companies in the two-way deal process and to prevent the low-loss ERPs from accepting voluntary contracts from other companies. It is not clear how companies account for these payments to agencies, but they may pass all or a portion of these payments on to consumers.

The inequitable distribution of losses creates the potential for actual or perceived conflict of interest for CAR's Board of Directors. Since companies do not share losses equitably, any rule changes will advantage or disadvantage companies or agencies represented by members of CAR's Board. For example, a rule change requiring an equitable sharing of losses will almost certainly reduce, and may eliminate, many of the poaching and anti-poaching payments from companies to ERPs, financially affecting those agencies. A company with many low-loss ERPs and few high-loss ERPs would, under an equitable sharing plan, see its ERP losses rise. Because the decisions of Board members directly affect competitors of companies represented on the Board, such conduct may be or may be perceived to be unfair or driven by personal interests rather than by the interest of the market as a whole. This is, in our view, one of the principal reasons for the statutory requirement of fair and equitable apportionment – to secure a conflict-free Board and to ensure that competitors do not manipulate the intricacies of a quasi-public corporation to obtain an unfair advantage over their competitors.

We are writing to you since you may request the submission of a new plan or amendments to the CAR plan. *See* G. L. c. 175, § 113H. It is our view that change in the CAR plan is necessary, and overdue, because the inequitable apportionment of ERP losses (i) has played a significant role in recent insolvencies and withdrawals of carriers from Massachusetts, events which have been disruptive to consumers and have cost policyholders millions of dollars, (ii) has added costs to the system in the form of poaching and anti-poaching payments to ERP agencies, costs the insurers may have passed and/or have attempted to pass on to consumers, and (iii) has been detrimental to Massachusetts policyholders by causing carriers to focus on gaming the CAR system rather than reducing costs or increasing services to policyholders.

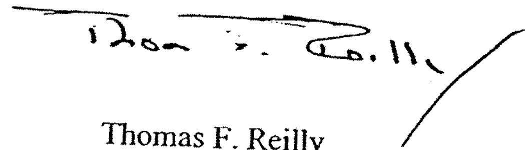
In addition, we believe that any return to competition in Massachusetts requires a fair residual market. The two principal expected benefits of a competitive market are competition between insurers currently in the market and the entry of low-cost or innovative insurers who are not currently in the market. Many current insurers either cannot or do not want to compete for business in Massachusetts because this means taking on additional ERPs which, if they are high-loss ERPs, would reduce rather than enhance profitability. Some current insurers (particularly smaller companies) cannot compete for business because their CAR financial burden leaves them little room to maneuver. And outside insurers are reluctant to enter the Massachusetts market because of their view that CAR is unfair and because of the demonstrable impact of this unfairness on profitability. In order for consumers to obtain the benefits of competition, there must be change at CAR.

Copies of this letter have been sent to CAR members in order to share with them the results of our data analysis. Over the last few months, several companies have proposed changes in CAR rules that would reduce or eliminate the inequity in the apportionment of ERP losses.

Insurers representing over a third of the market recently asked the Board to consider a proposal drafted by Liberty Mutual for study by the CAR Actuarial Committee. Although the Board summarily rejected the request for a study, we believe it is important for all CAR members to be informed of the nature of the problem and to have an opportunity to participate in crafting a solution that is fair and complies with the statute.

I hope that you share my concerns with the inequities in the CAR system. I would like to set up a meeting to further explore these issues and to begin to work jointly to reach an equitable result for Massachusetts consumers. Peter Leight on my staff will be contacting you shortly to arrange a meeting.

Sincerely,



Thomas F. Reilly

cc: CAR Members

Table 1

Calendar Accident Year 1996-2000

Company	Erp Loss Ratio*
Horace Mann	200%
Sentry	151%
Fitchburg Mutual	148%
State Farm	146%
USAA	138%
Trust	135%
Peoples Service	135%
Fireman's Fund	116%
New England Fidelity	115%
Arbella Mutual	114%
National Grange	113%
Safety	110%
Liberty Mutual	108%
Amica Mutual	107%
Commercial Union	99%
Hanover	96%
Metropolitan	95%
Plymouth Rock	91%
Holyoke Mutual	87%
Boston Old Colony	86%
Commerce	84%
Electric Insurance	82%
Norfolk & Dedham	80%
Premier	80%
Berkshire Mutual	77%
Quincy Mutual	76%
MassWest	75%
Total	104%

* Incurred Losses divided by premium for each companies business written through an Exclusive Representative Producer.

Table 2

Calendar Accident Year 1996-2000

Company	Percent of Total Losses Written through an ERP*
Horace Mann	69%
State Farm	64%
Sentry	61%
USAA	57%
Amica Mutual	53%
Fireman's Fund	51%
Fitchburg Mutual	50%
Peoples Service	49%
Trust	48%
New England Fidelity	44%
Arbella Mutual	42%
National Grange	41%
Liberty Mutual	40%
Boston Old Colony	37%
Safety	36%
Plymouth Rock	36%
Commerce	33%
Metropolitan	32%
Commercial Union	32%
Electric Insurance	31%
Premier	30%
Hanover	30%
Holyoke Mutual	29%
Norfolk & Dedham	29%
Quincy Mutual	27%
MassWest	27%
Berkshire Mutual	26%
Total	39%

* ERP losses divided by total company losses(ERP&voluntary)

Table 3

Calendar Accident Year 1996-2000

Company	Voluntary(non ERP) Loss Ratio
State Farm	39%
USAA	42%
Amica Mutual	48%
Premier	51%
Commercial Union	53%
Quincy Mutual	53%
Boston Old Colony	55%
Horace Mann	56%
Electric Insurance	57%
Fireman's Fund	58%
Safety	58%
Fitchburg Mutual	58%
Commerce	59%
Liberty Mutual	59%
Plymouth Rock	59%
National Grange	59%
Hanover	60%
MassWest	60%
New England Fidelity	60%
Holyoke Mutual	61%
Metropolitan	62%
Berkshire Mutual	63%
Arbella Mutual	65%
Sentry	65%
Norfolk & Dedham	66%
Maryland Casualty	68%
Trust	70%
Peoples Service	71%
Total	59%

TABLE 4

Total Market Erp Data*

Range	#Agencies	%Expos	%Incur Loss	%PrmCed	%LossCed
LR<20%	14	2.41%	0.03%	20%	24%
20%<LR<40%	47	3.01%	0.87%	17%	23%
40%<LR<60%	152	18.22%	9.01%	13%	18%
60%<LR<80%	195	23.57%	16.34%	17%	25%
80%<LR<100%	137	18.68%	17.03%	24%	35%
100%<LR<120%	81	14.58%	17.79%	32%	43%
120%<LR<140%	38	6.66%	9.48%	50%	64%
140%<LR<160%	28	5.41%	9.65%	70%	80%
160%<LR<180%	20	3.05%	6.30%	71%	76%
180%<LR<200%	5	0.51%	0.69%	48%	52%
200%<LR<250%	18	2.46%	7.30%	66%	72%
250%<LR<300%	9	0.82%	3.14%	80%	86%
300%<LR<400%	5	0.26%	1.17%	66%	77%
400%<LR	9	0.38%	1.21%	81%	76%
Total	758	100.00%	100.00%	31%	48%

* Calendar Accident Year 2000 Number of ERP Agencies, Percent of Exposures, Premium and Losses by ERP Loss Ratio Range with Respective Cession Rates or Number of Exposures Ceded to the Pool within That Range

Table 5

Calendar Accident Year 2000

Company	Percent of Losses from ERPs with Loss Ratios<80%*
Horace Mann	0%
State Farm	0%
USAA	0%
New England Fidelity	1%
Peoples Service	2%
Sentry	2%
Fireman's Fund	6%
Amica Mutual	7%
Fitchburg Mutual	9%
Safety	10%
Arbella Mutual	13%
National Grange	20%
Electric Insurance	28%
Hanover	28%
Holyoke Mutual	33%
Liberty Mutual	33%
Metropolitan	35%
Commercial Union	37%
Boston Old Colony	42%
Commerce	44%
Norfolk & Dedham	47%
Quincy Mutual	50%
Plymouth Rock	54%
Berkshire Mutual	57%
Premier	60%
MassWest	69%

* Losses written through ERPs with loss ratios less than eighty percent divided by total ERP losses.

Table 6

Calendar Accident Year 2000

Company	Percent of Losses from ERPs with Loss Ratios>160%*
State Farm	91%
New England Fidelity	90%
Fitchburg Mutual	84%
Horace Mann	60%
USAA	46%
Sentry	38%
Safety	34%
Arbella Mutual	30%
Fireman's Fund	30%
Peoples Service	28%
Commercial Union	27%
Plymouth Rock	20%
Norfolk & Dedham	18%
Liberty Mutual	13%
Amica Mutual	10%
Metropolitan	8%
Boston Old Colony	7%
Commerce	1%
Hanover	1%
Premier	1%
Berkshire Mutual	0%
Electric Insurance	0%
Holyoke Mutual	0%
MassWest	0%
National Grange	0%
Quincy Mutual	0%

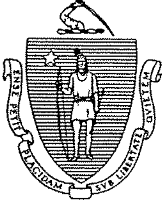
* Losses written through ERPs with loss ratios greater than 160 percent divided by total ERP losses.

Table 7

Comparison of Results Under Current System With What Results Would Have Been Under an Equitable System
Calendar Accident Year 1996-2000

Company	Benefit/ Loss Under Current System(000)*
Commerce	170,899
Metropolitan	31,610
Safety	18,706
Hanover	13,122
Berkshire Mutual	7,835
Norfolk & Dedham	4,028
Plymouth Rock	4,022
MassWest	1,245
Quincy Mutual	769
Holyoke Mutual	736
Premier	402
Electric Insurance	-130
Boston Old Colony	-605
New England Fidelity**	-1,912
Maryland Casualty	-2,082
Fitchburg Mutual	-3,094
Peoples Service	-4,507
State Farm	-6,576
Trust	-8,497
National Grange	-10,722
Fireman's Fund	-13,445
Horace Mann	-14,203
Liberty Mutual	-16,384
Commercial Union	-25,162
USAA	-30,115
Amica Mutual	-32,927
Sentry	-41,937
Arbella Mutual	-51,420
	-10,344

* Estimated difference in company net income 1996-2000 between current plan and fair share.
** New England Fidelity loss indicated is for Calendar Accident Year 2000 only



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AND BUSINESS REGULATION

JULIANNE M. BOWLER
COMMISSIONER OF INSURANCE

OPINION, FINDINGS AND DECISION

ON THE OPERATION OF COMPETITION

AMONG MOTOR VEHICLE INSURERS

June 7, 2002

Docket No. R2002-02

On March 25, 2002, the Division of Insurance ("Division") issued a notice of public hearing, pursuant to the requirements of G.L. c. 175E, §5, to consider whether the fix-and-establish rate setting procedure followed to set private passenger automobile insurance rates for 2002 should be renewed to set such rates for 2003. The statute requires the Commissioner of Insurance ("Commissioner") to determine annually, with respect to any territory or to any kind, subdivision or class of motor vehicle insurance, whether competition is either a) insufficient to assure that rates will not be excessive; or b) so conducted as to be destructive of competition or detrimental to the solvency of insurers. If the Commissioner finds that either condition exists, she must fix and establish the rates for such insurance or territory pursuant to G.L. c. 175, §113B. The hearing took place on April 18, 2002 at the Division's office in Boston.

Representatives of the Office of the Attorney General ("AG") and of the State Rating Bureau ("SRB") made oral presentations and submitted written statements at the hearing. In addition, Leonard Fisher, Esq., spoke. The hearing record was left open until May 10 to receive any additional written comment. Two such submissions were received.

The AG supports a return to competition in the long run, but believes that, despite recent successes in reducing and stabilizing rates, there is a continued need to regulate automobile insurance rates for 2003, and therefore recommends that the Commissioner fix-and-establish the rates for that year. He noted that the territorial system in place under the fix-and-establish system ensures that urban areas with high claims experience do not suffer unfairly. He stated that urban areas account for a disproportionately large percentage of claims dollars from all types of losses, and that this disproportion has changed little since 1988. Further, the AG stated, the disparity in claims experience among some urban and suburban communities may be even larger now that it was in 1977, when full competition was briefly tried. He pointed out that a shift to competition at this time could again result in disruptive rate increases for urban drivers, with minimal reductions to those in other communities. The AG asserted that any competitive system should include a subsidization and cost-sharing mechanism to protect urban policyholders from rate shock, and that until such a mechanism is in place, competition should not be implemented.

The AG observed that a 1998 report by the House Subcommittee on Automobile Insurance concluded that a "serious, in-depth" study needed to be performed before adoption of a competitive rating system. He noted, however, that no such study has been undertaken, and no other action has been taken by the insurance industry or any other group to develop recommendations for change. The AG commented that despite complaints about the rate reductions that have been implemented in recent years under the fix-and-establish system, the industry does not appear to have reached consensus on the issue of competitive rating.

The SRB noted that, in looking at options for increasing competition in Massachusetts automobile insurance, it is important to remember that the current system incorporates many different kinds of adjustments. Some of those adjustments reduce the cost of insurance for drivers in densely populated areas; others adjust the rates downward for inexperienced and younger drivers. While the SRB supports a transition to a more competitive rating system, it asserts that greater competitiveness should be accompanied by appropriate safeguards to ensure that rates do not increase dramatically for these groups of consumers, as they did when full competition was attempted in 1977.

Both the AG and the SRB noted that, over the last several years, some competition has been implemented within the fixed-and-established rate system. Consumers have benefited from rate deviations offered by insurance companies and from discount programs approved for members of associations and employee groups. The AG especially applauds programs that lower rates for drivers with good driving records, and expressed disappointment at the reductions that have occurred over the past two years in controlled competition within the current regulatory framework. He characterized the reductions in deviations and discount programs as a step backward.

The industry as a whole made no statement at the hearing. By letter dated May 7, the Automobile Insurers Bureau ("AIB") stated that it took no position on the merits of the issue to be decided in the competition hearing, but wrote to point out, as it has in past rate hearings, that the application of territorial rate constraints in the calculation of insurance rates results in what it considers to be some unintentional subsidies. It expressed its intention to raise the question of these subsidies in the hearings on 2003 rates, and its opinion that the existence of such subsidies impedes any move to competition.

Also on May 7, the Plymouth Rock Assurance Company ("Plymouth Rock") submitted comments for inclusion in the record of this proceeding. Plymouth Rock agrees with those who testified that Massachusetts is not ready for full-scale competition. It states that elements of competition, such as step deviations and group discounts have been incorporated into the fix-and-establish system and that, in its opinion, the current system offers room for more competition. It asserts that two innovations would have a beneficial effect on competition and consumer choice: 1) the establishment, at the Division, of procedures for company filings of optional endorsements and riders; and 2) the collection and maintenance at the Division of valid, verified statistics on consumer complaints by market share, which would be available to the public. The first proposal, Plymouth Rock argues, would benefit consumers by encouraging companies to develop and offer riders and endorsements that would differentiate their products and complement the coverages available under the mandated rates. Underlying Plymouth Rock's second proposal is the premise that two components influence consumer choice in selecting automobile insurance: price and service. Under the current system, consumers may have some price options available to them, but they do not have information on service that enables them to make informed decisions. Plymouth Rock asserts that a sister company, which operates in New Jersey, a state which maintains a complaint system, has found that the release of valid complaint statistics benefits the public and allows competition based on service.

The speakers at the hearing generally support the goal of ultimately returning to competition in private passenger automobile rates, but no person recommended that competition be instituted at this time. The interest in moving toward fully competitive rating is tempered by the recognition that, when instituted in 1977, unfettered competition produced unacceptable results. As the speakers noted, the adjustments that are incorporated into the fix-and-establish system temper the rates for operators who live in densely populated areas and those with less driving experience. Absent development of some safeguards within a competitive rating system, there is concern that urban and less-experienced drivers would probably be confronted, as they were in 1977, with extraordinary rate increases. For that reason, any shift to full competition should be based on careful analysis and planning to ensure that the system is structured to avoid the recurrence of that undesirable result.

At this time no recent in-depth study of the issues surrounding a shift to a full competitive rating system has been conducted and no proposal has been developed that addresses the concerns raised at this hearing about the potential consequences of a move to full competition. One speaker raised the possibility of modifying the fix-and-establish system to allow insurers some flexibility to raise or lower rates; as has been noted in other decisions on competition, such an approach would require legislative authorization. At the same time, recent history makes apparent that within the fix-and-establish system competition is possible. The decline in price competition in the past two years is regrettable. However, decisions to offer deviations or discounts rest entirely with individual companies. Insurers have always had the opportunity to market their products by promoting the level of service that they offer.

Proposals to restructure or replace the current system for developing statewide insurance rates, as well as proposals to increase competition within the current system, affect all consumers and insurers. Such proposals are appropriately reached through analysis and discussion in a setting that permits the industry as a whole, consumers, regulatory and other government agencies, individual insurers, insurance producers, and other interested persons to be heard. I note that the task force formed in February 1990 brought together representatives of those groups.

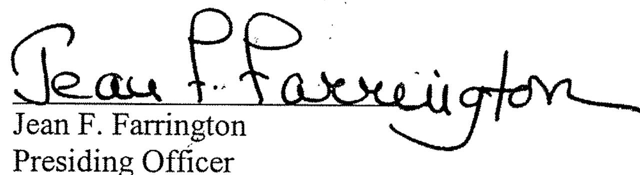
It is now over a decade since that task force made its report. Since then, no significant changes have been made to the fix-and-establish process, and competition among individual insurers has both waxed and waned. The Commissioner has concluded that it is time to form a new task force to reexamine issues relating to the current system and to the potential for competition within that system. However, the challenge to a task force addressing issues affecting the automobile insurance system is two-fold: to develop recommendations and to consider strategies for implementation. The history of proposals to make significant changes to the fix-and-establish system illustrates the difficulty of achieving speedy results. History also shows that individual insurance companies have the capacity to develop options including, but not limited to, riders or endorsements to the standard Massachusetts automobile policy that have the potential to increase competition without massive revisions to the system. To that end, I find it would be appropriate for a task force to consider alternatives that could be implemented within the fix-and-establish system including, but not limited to recommendations on appropriate subjects for

endorsements and for procedures to be followed by companies that wish to utilize this approach.

No one has proposed a method for going to a fully competitive system in 2003 and, on consideration of the written submissions and the statements made at the hearings, I conclude that a move to full competitive rating in 2003 is not feasible. Neither consumers nor insurers will benefit if full competitive rating is instituted without thoughtful planning and carefully structured implementation, including appropriate education programs. At the same time, it is my expectation that the task force will timely develop recommendations on competition within the fix-and-establish system so that consumers will be able to benefit from greater competition in 2003.

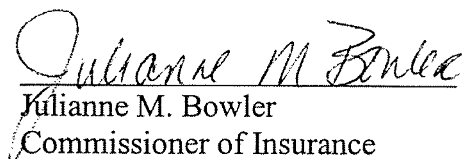
Based on the record of this proceeding, I find that present conditions are such that competition, if implemented in 2003, would be insufficient to assure that rates will not be excessive, and might be so conducted as to be destructive of competition. Therefore, with respect to the private passenger class, the procedures set forth in G.L. c. 175, whereby the Commissioner fixes and establishes rates, and insurers may apply to deviate from those rates, will continue to be used for all coverages for calendar year 2003.

This decision has been filed this 7th day of June, 2002 in the office of the Commissioner of Insurance and with the Secretary of State as a public document. Any party aggrieved by this decision may, within twenty days, file a petition for review in the Supreme Judicial Court for Suffolk County.



Jean F. Farrington
Presiding Officer

Affirmed:



Julianne M. Bowler
Commissioner of Insurance

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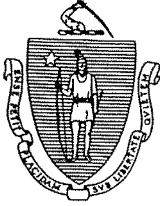
DIVISION OF INSURANCE



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JULIANNE M. BOWLER
COMMISSIONER OF INSURANCE

Docket No. R2003-09

The Operation of Competition Among Motor Vehicle Insurers

Order

After review of the testimony and written material presented in this proceeding, I have determined that additional information is needed to make a determination on the sufficiency or conduct of competition in the Massachusetts private passenger automobile insurance market. Accordingly, the record of this proceeding will remain open through July 8, 2003 to allow interested persons the opportunity to provide additional written submissions to address certain of the proposals presented.

At the May 16, 2003 hearing, several speakers offered testimony suggesting various ways in which the Massachusetts private passenger auto market could transition into some form of competition. These speakers either stated or implied that the Commissioner currently has the authority to initiate limited means of competition immediately; however no explicit statutory or common law authorities were cited in support of these positions. In order to determine what form competition can take under the current statutory framework, I hereby request briefs analyzing the extent of statutory and common-law support for the following proposals.

1. Testimony was offered concerning the Commissioner's authority to allow companies to offer optional endorsements, and some suggest this can be done on a file and use basis. Please provide an analysis of the specific statutory and/or common law bases for this position. If it is your opinion that this proposal is not supported by the current statutory framework or common law, please submit that analysis.

2. Testimony was offered suggesting the Commissioner currently has the authority to set the rate, but to allow companies to offer rate deviations by the use of "flex bands," i.e., permitting competitive pricing within a fixed percentage range above and below the established rate. Please provide an analysis of the specific statutory and common law bases for this position. If it is your opinion that this proposal is not supported by the current statutory framework or common law, please submit that analysis.

3. Testimony was offered suggesting the Commissioner has the authority and discretion to set the expense allowance for the industry as a percentage band to be applied to loss costs in developing expense pure premium in the context of the fix and establish rate-setting process, rather than setting expense pure premium as a single factor. Please provide an analysis of the specific statutory and common law bases for this position. If it is your opinion that this proposal is not supported by the current statutory framework or common law, please submit that analysis.

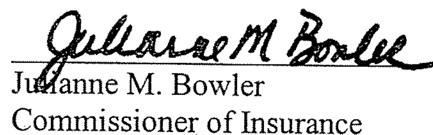
4. Testimony was offered proposing a system under which individual insurance companies would set the base rate, and the Commissioner would establish the class and territorial relativities. Please provide an analysis of the specific statutory and common law bases for this position. If it is your opinion that this proposal is not supported by the current statutory framework or common law, please submit that analysis.

5. Testimony was offered to suggest the Commissioner, while fixing-and-establishing the rates for the compulsory coverages, could allow companies more freedom in the pricing of one or more optional coverages, possibly through the use of flex rating bands. Please provide an analysis of the specific statutory and common law bases for this position. If it is your opinion that this proposal is not supported by the current statutory framework or common law, please submit that analysis.

These questions will be posted on the Internet at www.state.ma.us/doi, and will be provided directly to all who offered testimony at the public hearing May 16, 2003. Any interested person may provide a response to any or all of these questions, regardless of whether that person addressed that proposal at the hearing.

So ordered.

June 20, 2003



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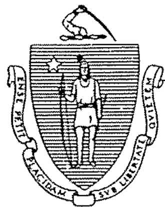

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COMMISSIONER OF INSURANCE

OPINION, FINDINGS AND DECISION

ON THE OPERATION OF COMPETITION

AMONG MOTOR VEHICLE INSURERS

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August 8, 2003 **Docket No. R2003-09**

I. Introduction and Procedural History

On April 17, 2003, the Division of Insurance ("Division") issued a notice of public hearing, pursuant to the requirements of G.L. c. 175E, §5, to consider whether the fix-and-establish rate setting procedure followed to set private passenger automobile insurance rates for 2003 should be renewed to set such rates for 2004. Under the statute, the Commissioner of Insurance ("Commissioner") must determine annually, "with respect to any territory or to any kind, subdivision or class of motor vehicle insurance, whether competition is either a) insufficient to assure that rates will not be excessive; or b) so conducted as to be destructive of competition or detrimental to the solvency of insurers." If the Commissioner finds that either condition exists, she must fix and establish the rates for such insurance or territory pursuant to G.L. c. 175, §113B. The hearing took place on May 16, 2003 at the Division's office in Boston.

Attendance at and participation in the competition hearing this year far exceeded that of recent years. In addition to representatives of the Office of the Attorney General ("AG") and of the State Rating Bureau ("SRB"), speakers included State Representative Anne Paulsen and individuals testifying on behalf of six insurance trade associations. Presentations were made on behalf of seven insurers that write private passenger automobile insurance in Massachusetts. In addition, two individuals, Leonard Fisher, Esq., and John Hayes offered comment. Four insurers submitted written comments before the hearing. The hearing record was initially left open until May 28; the AG, individual companies, and trade associations submitted written comment during that period.

On June 20, the Commissioner issued an order (the "June 20 Order") keeping the record open until July 8 to allow interested persons to provide additional written submissions on certain proposals presented at the May 16 hearing. Comment was solicited on five specific topics: 1) the Commissioner's authority to allow companies to offer optional endorsements to the standard private passenger automobile insurance policy, and whether such endorsements could be submitted on a file and use basis; 2) the Commissioner's authority to allow companies to offer rate deviations from fixed and established rates through the use of "flex bands," which would permit competitive pricing within a fixed percentage range above and below the established rates; 3) the Commissioner's authority, in the process of fixing and establishing rates, to set the

expense allowance for the industry as a percentage band to be applied to loss costs in developing expense pure premium, rather than setting expense pure premium as a single factor; 4) Adoption of a system in which individual insurance companies would set base rates, while the Commissioner would establish class and territorial relativities; and 5) adoption of a system in which the Commissioner would fix-and-establish rates for compulsory coverages, but insurers would be allowed to price one or more optional coverages, perhaps through the use of flex bands. Those submitting responses were asked to analyze whether current statutory and common law supports such proposals and, conversely, to provide an analysis of statutory and common law that would, in the author's opinion, demonstrate that the proposal is currently not permissible as a matter of law. The Commissioner received eight responses to the order, from the AG, the SRB, John Hayes, Commerce Insurance Company ("Commerce"), Hanover Insurance Company ("Hanover"), Liberty Mutual Insurance Company ("Liberty Mutual"), The Premier Insurance Company ("Premier"), Plymouth Rock Assurance Company ("Plymouth Rock") and, through a joint submission, six insurance trade associations ("Trade Associations") whose members include sixteen of nineteen servicing carriers offering private passenger automobile insurance in Massachusetts.[1] This decision will first review the statements made at the May 16 hearing and additional written commentary received by May 28, and then consider the submissions received in response to the June 20 Order.

II. Summary of Statements and Initial Written Commentary

The consensus among participants in the hearing was that, ultimately, premiums for private passenger motor vehicle insurance should be determined competitively by insurers that offer the product in the marketplace. That competitive market would allow Massachusetts consumers to choose insurance based on factors including price, coverage options, service and preferences for a particular carrier. At the same time, there was general agreement that the move to a competitive market must be designed to avoid the type of negative experience, particularly the dramatic increase in rates for urban and inexperienced drivers, that resulted from the decision to allow full competition in 1977. To that end, participants offered a wide range of proposals for shifting to a fully

[1] The six associations are the Alliance of American Insurers, the American Insurance Association, the Independent Property/Casualty Insurers of Massachusetts, the Massachusetts Insurance Federation and National Association of Independent Insurers and the National Association of Mutual Insurance Companies.

competitive market, opinions on the appropriate timetable for achieving that goal, and analyses of the conditions that need to exist before change is possible.

No single definition of a "competitive market" for private passenger automobile insurance in Massachusetts emerged from testimony at the hearing. For some participants, a competitive market is measured by the number of insurers that offer that product. Several speakers pointed to the recent decline in the number of companies in the marketplace as evidence that the market has become less competitive. Further, it was noted, a number of nationwide insurers either do not offer automobile insurance in Massachusetts, or write very little business here. However, one insurer argued that the absolute number of insurers offering auto insurance in Massachusetts is not a measure of competition, expressing the opinion that in any state, except for the top ten or so writers, the other carriers have little effect on competition. It asserted that viewing participation in terms of market share, rather than by the number of insurers, shows that market share distribution in Massachusetts is not unique. Generally, however, speakers support actions that would improve participation in the market by removing what are perceived as barriers to entry, both for existing nationwide companies and new companies. To that end, they identified several problems associated with the Massachusetts marketplace.

Almost every speaker, as well as those who submitted posthearing commentary, considered that reform of the Massachusetts residual market operated by Commonwealth Automobile Reinsurers ("CAR") is essential to implementing a competitive rating system.[2] The two principal targets of concern were 1) the formulas for distributing pool losses among insurers, which many speakers considered unfair, particularly to smaller insurance companies; and 2) the system for assigning exclusive representative producers ("ERPs") to servicing carriers. Some participants opined that the ERP system offers incentives to manipulate producers and is viewed as an opportunity for knowledgeable insurers to decrease their share of pool losses. Two specific alternatives to the current system for insuring risks who cannot obtain coverage on the voluntary market were proposed: 1) a shift to an assigned risk plan, which would assign individual operators to insurers; and 2) designation of a limited number of servicing carriers to manage all

[2] All insurers licensed to write private passenger automobile insurance in Massachusetts are members of CAR, and virtually all of those insurers who offer the product write sufficient premium to be classified as servicing carriers.

business ceded to the residual market, perhaps through oversight of ERPs with books of business showing high loss ratios. One speaker suggested basing an assigned risk plan on objective criteria for assignment of individual risks to the residual market, such an operator's Safe Driver Insurance Plan step.

Speakers also identified the Commonwealth's "take all comers" law, its "mandatory offer" requirements relating to increases in the amount of mandatory coverages and the offer of optional coverages, and the standard zero glass deductible as barriers to participation in the marketplace for private passenger automobile insurance. One insurer urged elimination of the current restriction that prohibits insurers within a company group from offering different rating tiers. Companies operating on a nationwide basis, it was pointed out, incur additional expenses to maintain systems that are unique to Massachusetts. Two insurers commented on the need for better procedures for fighting both premium fraud and claim fraud, but offered no specific recommendations for change.

Another measure of competition is the extent to which individual companies differentiate themselves in the insurance marketplace on the basis of price and variety of product. Massachusetts insurers, beginning the mid 1990s, began to compete on price, utilizing a provision in the fix-and-establish system that allows them to deviate downward, but not upward, from the Commissioner's rates, expanding the group discounts permitted under G. L. c. 175, §193R, and changing company-provided finance plans to reduce costs to consumers. In recent years, however, companies have reduced their utilization of price competition options that are permitted under the fix-and-establish system.

Participants in this hearing made several observations about the conditions that support price competition. First, they note, competition requires rate levels that are perceived to be adequate. The fix-and-establish system, they assert, creates a rigid pricing structure that flattens rates and incorporates cross-subsidies that do not permit risks to be priced accurately. One speaker, representing a trade association, asserted that territorial and class cross-subsidies are imposed administratively, rather than by statute, and that while they may have originally been justified for social or political reasons, they seriously distort the pricing of private passenger automobile insurance. Good drivers, he alleged, pay too much and bad drivers pay too little. A company representative commented that even if social policy supports cross-subsidizations, the level in Massachusetts is higher

than in other states. He asserted that cross-subsidization burdens consumers, and may avoid the opportunity to provide an economic incentive for high risk operators to alter their driving behavior. Commerce noted that changes to the rating system should both reduce cross-subsidies and allow higher rates for specific high risk segments of the market, such as urban and youthful drivers.

As noted above, participants in the hearing universally recognized the importance of avoiding the results of the 1977 move to full competition. Their proposed alternatives to an abrupt shift to competition generally addressed two areas, price competition and product competition.

Several proposals would create hybrid systems combining some aspects of the fix-and-establish procedure with competitive pricing. Currently, the Commissioner fixes and establishes rates for all coverages offered under the standard motor vehicle insurance policy, both mandatory and optional, a process that includes approval of rate relativities based on territory and driver class.[3] One proposal would continue the fix-and-establish process for the four mandatory coverages, but permit insurers to offer competitive rates for the optional coverages. Another would allow the companies to set base rates, to which they would apply class and territorial relativities fixed by the Commissioner. Several speakers suggested modifying the fix-and-establish system to allow the Commissioner to set "flexbands" within which insurers could increase or decrease rates. One proposal would continue the fix-and-establish procedure for base rates, and then allow companies to set their own rates within rating bands. It was also suggested that, if competitive rating were allowed for optional coverages, those competitive rates should be, at least for a transition period, limited within flex bands. For any competitive rating system, insurers urge adoption of a file and use procedure, rather than a prior approval process.

A second proposal for increasing flexibility within the fix-and-establish system, made by industry trade associations, recommended that the Commissioner change the current methodology for determining the appropriate provision for company expenses in the rates. They suggest that the Commissioner's rate decision establish a permissible band

[3] Operators in Massachusetts must purchase basic liability coverage for bodily injury and property damage, personal injury protection, and uninsured motorist coverage; all other coverages included in the standard policy are optional. These include increased limits for mandatory coverages, collision, limited collision, comprehensive, medical payments, towing and labor, substitute transportation and underinsured motorist coverage.

of expenses as a percentage of loss costs; individual insurers would then file with the Division the expense multiplier that they intended to use in their rates. The proposal, they note, contemplates no change to the existing process of making a single filing on behalf of the industry.

Speakers identified the insurance contract as another arena for potential competition. Currently, insurers utilize a single policy form for private passenger automobile insurance that incorporates twelve standard coverages. In addition, over time, a number of endorsements to that policy have been developed for insurers' general use.[4] Under the fix-and-establish system, the Commissioner may reduce premium charges for optional policy provisions that will result in savings through reduced costs. Several participants at the hearing urged the Commissioner to permit insurers to offer optional endorsements that would complement the coverages available under the standard policy, by providing enhanced coverage at rates that would be determined by the insurer. They propose that insurers submit endorsements and rates on a "file and use" basis, pricing the endorsements competitively. Such endorsements, it is asserted, would permit some innovation in the marketplace, increase diversity in product alternatives, and provide consumers with some experience of competition. The AG expressed concerns about offering endorsements without any regulation, commenting that Division of Insurance oversight of both the substance and pricing of such endorsements is necessary to ensure that they benefit policyholders. He argues as well that the "unregulated" sale of endorsements is inconsistent with several aspects of the fix-and-establish system and that, if such endorsements were offered, provision should be made for the appropriate maintenance and reporting of data relating to those endorsements, so that it is not commingled with data underlying the fixed-and-established rates.[5]

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[4] An index to those endorsements may be found on the website of the Automobile Insurers Bureau.

[5] Although references were made to the "unregulated" sale of endorsements, Massachusetts statutes requires insurers who intend to sell motor vehicle policies or endorsements to file the forms and the rates with the Commissioner prior to use. This "file and use" process lies in the middle of a wide continuum of systems for regulatory oversight, ranging from fix-and-establish and prior approval mechanisms to "use and file" and "no filing required" systems. The Commissioner has authority to review and to approve or disapprove endorsements under G.L. c. 175, §113A, and to review rates under c. 175E or c. 175, §113B, as appropriate. Data collection relating to premiums, losses, expenses, and any other aspect of motor vehicle insurance, including endorsements, once it is on the market, is regulated through statistical plans that the Commissioner oversees.

A third mode of competition, customer service, was also raised at the hearing. Plymouth Rock argued that consumers would benefit from a system permitting insurers to compete on service as well as price and product and proposed, as it has in the past, that the Division collect, maintain, and make available to the public valid, verified statistics on consumer complaints by market share. Such an innovation would, it asserts, have a beneficial effect on competition and consumer choice. The premise underlying Plymouth Rock's proposal is that both price and service influence consumer choice in selecting automobile insurance and that, while consumers may now have some price options available to them, they do not have information on service that enables them to make informed decisions. Plymouth Rock asserts that a sister company, which operates in New Jersey, a state which maintains a complaint system, has found that the release of valid complaint statistics benefits the public and allows competition based on service. Plymouth Rock volunteered to provide additional information to the Division on the operation of the New Jersey system, including its standards for screening complaints. The AG concurs that complaint statistics would be useful, and has offered to share the data that he collects on his insurance hotline.

As evidence that systems regulating automobile insurance can be successfully changed, participants in the hearing pointed to the recent experience of several other states. South Carolina, Illinois, New Jersey and Texas were identified as states in which some of the reform measures offered for Massachusetts have been successfully implemented.

III. Responses to the June 20 Order

Identifying G.L. c. 175E, §5 as the statutory basis for the Commissioner's authority to fix and establish private passenger automobile insurance rates, the Trade Associations, Liberty Mutual, and Hanover assert that Massachusetts law carries a presumption that competition exists.[6] Hanover argues that, by enacting G.L. c. 175E, the Legislature envisioned a competitive system, one in which, according to a 1977 article in the *Massachusetts Law Quarterly*, the Commissioner would take an active role to encourage competitive behavior. As evidence of legislative intent, Hanover cites an

[6] The joint submission erroneously refers to c. 174 as the source of the Commissioner's authority. However, in testimony at the May 16 hearing, the citation was correct.

additional comment in that article, that the market for automobile insurance "should be regulated by competition to the extent that competition is active and effective." Hanover and Premier note that the rates are to be fixed and established only in limited circumstances, after a determination whether, "with respect to any territory or to any kind, subdivision or class of insurance competition is either (i) insufficient to assure that rates will not be excessive, or (ii) so conducted to be destructive of competition or detrimental to the solvency of insurers."

Although there appears to be no genuine dispute over the statutory source of the Commissioner's authority to fix and establish rates, the eight responses to the June 20 Order demonstrate that there are differences of opinion on the extent of her authority, both under that law and under G.L. c. 175, §113B, to implement the alternatives proposed at the hearing. Even for proposals that are perceived as legally permissible, respondents voiced reservations about whether public policy would support their adoption, and raised other concerns about their effect on the system as a whole, particularly the residual market. Plymouth Rock observes that motor vehicle insurance rates are evaluated under similar statutory standards, whether they are reviewed pursuant to c. 175E or c. 175, §113B. Under c. 175E, rates must not be "excessive or inadequate" or "unfairly discriminatory;" a decision issued under c. 175, §113B must result in "fair and reasonable classifications of risks" and "adequate, just, reasonable and nondiscriminatory premium charges." Plymouth Rock comments that changes that result in dramatic rate increases for some classes of drivers could result in claims of unfair discrimination, and urges the Commissioner to take a slow, incremental approach to reform.

A. Question 1

The first question in the June 20 Order sought comment on the Commissioner's authority to allow companies to offer optional endorsements to the standard private passenger automobile insurance policy, and whether such endorsements could be submitted on a file and use basis. The responses addressing that question do not dispute, generally, that the Commissioner has authority to allow companies to offer optional endorsements to the standard private passenger automobile insurance policy, but rely on different rationales to support that conclusion. Premier argues that the Commissioner's authority, under G.L. c. 175E, §5, to exempt from the ratesetting process any subdivision,

kind or class of insurance is sufficient to exempt optional endorsements from the fix-and-establish proceeding. Plymouth Rock reasons that because optional endorsements might be interpreted to be "a kind, subdivision or class of insurance," the Commissioner could fix and establish the rates generally, but allow companies to set their own rates for such endorsements. It takes the position that G.L. c. 175, §§22A and 113A permit insurers to file riders and endorsements to motor vehicle policies so long as the riders or endorsements do not conflict with other statutory provisions. Plymouth Rock argues, in addition, that the fix-and-establish procedure set out in c. 175, §113B applies to rate deviations, but not to endorsements.[7]

The Trade Associations argue that Massachusetts statutes require motor vehicle insurance policies to provide certain coverages, referring specifically to certain sections of G.L. c. 90, but that those statutes are silent on the question of offering other coverages. They assert that, pursuant to G.L. c. 175, §3, the Commissioner has broad authority to issue any coverage authorized by law, pointing out that G.L. c. 175, §47 authorizes many types of insurance coverage. The Trade Associations conclude that there is no blanket statutory prohibition on approving optional endorsements, and rely on the deference afforded by the courts to the Commissioner's decisions to support offering such endorsements.

The State Rating Bureau concurs that G.L. c. 175, §113A permits motor vehicle insurance policies to contain provisions other than those in the standard policy so long as any endorsement is not inconsistent with the provisions of c. 175 and of G.L. c. 90, §34A. It notes that a determination on whether an endorsement satisfies the statutory standard must be reached on a case by case basis. Acknowledging concerns raised about accounting, in a fix-and-establish system, for expenses and premium income related to the sale of such endorsements, the SRB concludes that optional endorsements are not categorically prohibited.

The AG, in his response, takes no affirmative or negative position on the permissibility of optional endorsements, but again comments on the effects that their "unregulated" sale will have on the fix-and-establish rating system. He reiterates that, in

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[7] Plymouth Rock's position was set out in a memorandum it prepared in 2001 addressing endorsements and rate filings in the field of private passenger automobile insurance. It submitted a copy of that memorandum with its response to the June 20 Order.

order to produce actuarially appropriate rates within the fix-and-establish system, it would be essential either to include or to exclude in their entirety premiums, losses, expenses, and profits generated by each such endorsement. The AG notes that including this information in the data used to fix-and-establish rates is inconsistent with the companies' stated preference for "unregulated" sales. Further addressing problems of treating data on optional endorsements within the fix-and-establish system, he observes that, on the expense side, companies do not now report expenses by coverage, and would not be able to segregate expenses related to each endorsement. Excluding data on endorsements would present a different challenge to the profits model. Because underwriting profits models incorporate an analysis of cash flows, insurers would confront what the AG describes as a virtually impossible task of removing cash flows specifically associated with endorsements.

B. Question 2

The second question in the June 20 Order asked for analyses of the Commissioner's authority to allow companies to deviate from fixed and established rates through the use of flex bands which would permit competitive pricing above and below the established rates. Premier asserts that Massachusetts law provides no express statutory authority for use of flexbands, whether rates are fixed and established under c. 175, §113B or filed under c. 175E. It notes that c. 175E, §4 calls for the use of company-specific losses and expenses, not flex bands, to evaluate individual company filings and takes the position that what must be approved under either statute are "rates" not ranges.

Plymouth Rock states that it has found nothing in statute or case law that would specifically prohibit the Commissioner from exercising flexibility in fixing or establishing rates. Focusing on the Commissioner's authority under c. 175E, §4, Plymouth Rock offers two possible interpretations that might be applied to the issue of flexbanding. A broad interpretation of the statute, Plymouth Rock argues, would conclude that the right to fix and establish rates is not an "all or nothing" right, but permits the Commissioner to fix and establish some rate categories while leaving others open to competition. A broader interpretation would also be based on the argument that, if the Commissioner has authority to absolutely fix and establish rates, she must also be authorized to take any lesser approach. Under that interpretation, Plymouth Rock concludes, the Commissioner

might determine that competition is adequate to allow insurers to set their own rates, but only within certain limits, or bands.

The second, and narrower, interpretation of c. 175E that Plymouth Rock sets forth is that the word "fix" requires precise rates, permitting the Commissioner flexibility only with regard to "any territory, or to any kind, subdivision or class of insurance." It observes that c. 175, §113B provides a detailed description of the ratesetting process, and argues that the level of detail in the statute suggests that the Legislature, had it wished to allow flex bands or other approaches, would have specifically addressed them. Plymouth Rock concludes that the Commissioner's authority to adopt a flexbanding approach to ratesetting is uncertain, and that she should seek specific legislative approval before adopting it.

The Trade Associations analyse the Commissioner's authority to allow flexibility in motor vehicle insurance rates under a two-step process enunciated by the United States Supreme Court in *Chevron, USA, Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). That review began with the premise that, on review of an agency decision interpreting a statute that it administers, the court first considers whether the agency's interpretation is consonant with the legislative intent. If the legislative body did not directly address the precise question at issue, the court must determine whether the agency's interpretation is based on a permissible construction of the statute. In the opinion of the Trade Associations, Massachusetts statutes relating to motor vehicle insurance rates do not convey legislative intent about the permissibility of flexband rating. Therefore, they conclude, the Commissioner would be entitled to infer such authority, provided her decision is predicated on substantial evidence. Further, they assert, the change would be reasonable because little actual change in premiums would result. The Trade Associations believe that the courts would respect the Commissioner's analysis of the ratesetting statutes, and would uphold changes to the current system.

Hanover argues that, even if the Commissioner decided to implement fix-and-establish ratesetting for a particular rate year, she could still build some competitive features into that process. It asserts that the Commisioner can allow companies to use flex bands, which would permit competitive pricing within a fixed range. Based on language in the decision in *Massachusetts Bonding & Insurance Co. v. Commissioner of Insurance*,

329 Mass. 265, 270 (1952) stating that the Commissioner's duty under §113B is to fix "a rate that lies somewhere between the lowest rate that is not confiscatory and the highest rate that is not excessive or extortionate," Hanover asserts that there is no reason to believe that the Legislature intended the fixed-and-established rate to be a "static" number. Citing to a series of decisions challenging rates fixed-and-established by the Commissioner, it comments that rates need not be set with mathematical precision and concludes that there is always a range of reasonable and adequate rates that the Commissioner can establish. In response to concerns that G.L. c. 175, §113B only authorizes companies to discount below the fixed rates, Hanover suggests that the Commissioner could set rates at the higher end of the rates legally permissible under the statutory standard, and then permit companies to discount from that rate. Further, Hanover argues, even if the statute specifically authorizes companies to discount downward from the fixed and established rates, that language may not preclude establishing ranges or rates which could be deviated upward or downward. Hanover concludes that because any fixed-and-established rate is selected from a potential range of values, it is permissible to establish a range of rates, so long as the end result is reasonable.

The AG, commenting on flexbanding in his first post-hearing written submission, considered that it might be a helpful transitional rating system, but opposed its adoption at this time. He takes the position that flexband rating should not occur outside of a clear plan, including timetables, to alter the Massachusetts system and that it should not be adopted before CAR is reformed. The AG argues, as well, that flexband rating would almost certainly be challenged as outside the scope of the Commissioner's current statutory authority.[8]

C. Question 3

The third question in the June 20 Order related to the Commissioner's authority to set the expense allowance for the industry as a percentage band to be applied to loss costs in developing expense pure premium. As noted above, the proponents of this approach offered it as an alternative methodology to be applied in fixing and establishing rates under c. 175, §113B. Responses to this question demonstrated divergent opinions on the

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[8] This issue has been raised in competition hearings in previous years, with the suggestion that such an approach would require legislative authorization.

Commissioner's authority to flexband the expense component of fixed and established rates. Premier again notes that c. 175, §113B provides no express authority to use a flexbanding concept, but argues that a decision that concluded that flexbanding of expense provisions is a matter within the Commissioner's discretion might be upheld on appeal. Hanover supports the principle that this issue is within the Commissioner's discretion, analogizing it to the Commissioner's obligation, in setting rates under §113B, to evaluate the industry's cost control measures, and arguing that she has broad discretion in this matter.

Plymouth Rock applies its analysis of flexbanding to Question 3, concluding that the Commissioner's authority is uncertain, and again recommending seeking legislative approval.

D. Question 4

The fourth question in the June 20 Order asked for commentary on adoption of a system in which individual insurance companies would set base rates, but apply them subject to class and territorial relativities set by the Commissioner. Liberty Mutual's written submission reiterates its proposal to introduce competition into the Massachusetts market by inaugurating such a system. Liberty Mutual asserts that such a system would permit competition, maintain stability in the market, and ensure that carriers would not focus only on some territories. It argues that c. 175E §5 authorizes the Commissioner to find that competition is insufficient only in some portions of the market, and to fix and establish rates for those portions. According to Liberty Mutual, relativities could be set by regulation, noting that in 1976, following enactment of c. 175E, the Commissioner promulgated regulations prescribing a formula for the calculation of territorial relativities.[9] Premier and Hanover agree with Liberty Mutual that c. 175E allows the Commissioner to determine that competition is adequate in some or all classes or territories. Premier observes that to implement Liberty Mutual's proposal, the Commissioner would be required to find, first, that competition was insufficient to ensure that rates would not be excessive and was conducted so as not to violate the statute, and then to decide that, with

[9] Schedule K to 211 CMR 76.00, a regulation no longer in effect that prescribed the forms for individual company filings under c. 175E, established the methodology to be used by the company to develop territorial relativities. The October 1976 *Decision on Proposed Territories for 1977* pointed out that the hearing did not address territorial differentials and rates because, under the new competitive rating law, different companies may file different territorial differentials and rates.

respect to class and territorial relativities, competition was insufficient to meet either statutory standard. Hanover points out that the Commissioner would still be obliged to determine whether rates are excessive, inadequate or unfairly discriminatory. To that end, it proposes that she, by regulation or order, issue benchmarks to insurers establishing the ranges in which they could operate. Hanover further argues that Liberty Mutual's proposal would move toward competition while avoiding the sharp rate swings experience in 1976. In Plymouth Rock's viewpoint, there is a good argument that current law does not permit Liberty Mutual's proposed approach, and that legislative approval would be required.

E. Question 5

Question five in the June 20 Order sought commentary on adoption of a system in which the Commissioner would fix-and-establish rates for compulsory coverages under c. 175, §113B, but allow insurers to price one or more optional coverages competitively under c. 175E, perhaps through the use of flex bands. Hanover characterizes the proposal as a regulatory middle ground, commenting that the courts would give great deference to any decision combining both approaches. Other responses consider that excluding optional coverages from the fix-and-establish procedure may be permissible, but raise questions about the advisability of such an approach. While Plymouth Rock asserts that the Commissioner has authority to exclude any "kind, subdivision or class of insurance" from the fix-and-establish system, it also notes that adoption of any of the flexible rating approaches identified in the June 20 Order could have an effect on policies that are ceded to the residual market. Specifically, it asks the Commissioner to consider how competitive pricing for optional coverages would apply to ceded policies. Premier agrees that c. 175E would support carving out some coverages for competitive pricing, but reiterates its position that the statute probably does not support flexband rating. At the same time, it opposes allowing competitive pricing for optional coverages, arguing that it would not induce companies to stay in or to join the market, and is not consistent with sound public policy. Premier asserts that because above average risks purchase optional coverages, carriers would compete only for the generally more profitable business, without the ability to balance premium reductions for these drivers with surcharges on the less profitable business.

The AG comments that optional coverages now represent a significant portion of the fixed-and-established rates noting, for example, that almost three-quarters of all policyholders purchase collision coverage. He argues that any impact on the cost of optional coverages that results from competitive rating will therefore have a large-scale impact on the many policyholders who purchase those coverages. The AG notes, as well, that the "unregulated" sale of optional coverages would have an actuarial effect on the fix-and-establish rating process comparable to that of "unregulated" sales of optional endorsements.[10] To that end, he points out that it would be necessary to establish a system for uniform treatment of data related to the sale of optional coverages within the system for fixing and establishing rates for mandatory coverages, and to take account of profits from such sales in the profit model.

F. General Responses

The June 20 Order asked respondents to consider not only whether current law would support proposed alternative approaches to the current process for fixing and establishing rates, such as flexbanding or excluding some components from that process, but also to consider whether it prohibits such arrangements. The SRB's response did not comment separately on the issues raised in questions two through five, but asserted generally that the proposals at issue appear to conflict with current law, and would require legislative change. It recommends moving to competitive rating over the course of several years, while taking initiatives in 2004 to ensure equitable distribution of pool losses. The SRB asserts that such modifications can be made within the current statutory framework. Further, it argues, a shift to more competitive rating could be accomplished more effectively and with greater market stability under a revised statutory scheme that is designed to support competitive rating. The SRB also urges review of the Safe Driver Insurance Plan, asserting that within the current statutory framework it may be possible to create additional rewards and incentives for the safest Massachusetts drivers.

Commerce, referring to testimony given at the May 16 hearing, reiterated its position that legislative action would be needed to establish a rating scheme that would reduce subsidies and allow for higher rates for specific high-risk segments of the market,

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[10] See discussion at p. 10.

such as urban and "youthful" drivers.[11] Plymouth Rock, although it offered interpretations of the current law that might allow flexbanding, concluded that the Commissioner's authority to adopt such an approach to ratesetting is uncertain, and recommended that she seek specific legislative approval before adopting it.

IV. Analysis and Conclusion on Competition

G.L. c. 175E sets out two pathways for ensuring that motor vehicle insurance rates will not be excessive, inadequate, or unfairly discriminatory. One path permits insurers, or rating organizations on their behalf, independently to file rates and manuals for use in Massachusetts, subject to standards set out in the statute. The second path authorizes the Commissioner to fix-and-establish the rates, if she first determines that competition is insufficient to ensure that rates for any territory or any kind, subdivision or class of motor vehicle insurance will not be excessive, or that it is so conducted as to be destructive to competition or detrimental to the solvency of insurers. The Legislature's provision for an annual hearing on the state of the competitive market recognizes that motor vehicle insurance rates submitted under c. 175E should not be excessive, inadequate or unfairly discriminatory, and that competition could be conducted in ways that would be destructive of or detrimental to insurer solvency. The Commissioner's responsibility under c. 175E, §5 is not to find whether competition exists, but to make a determination that competitive activity itself, and the rates it produces, comply with the statutory standards in c. 175E.

The Massachusetts requirement that motor vehicles be insured as a condition for registration creates a significant market for automobile insurance. As noted in the decision in *American Manufacturers Mutual Insurance Company v Commissioner of Insurance*, 374 Mass. 181 (1978), the extent of rate regulation has varied over time. In 1976, the decision was made to allow full competition in motor vehicle insurance rates beginning in January 1977. The experiment generated steep rate increases, particularly for urban and inexperienced drivers, and resulted in legislative action reversing those increases and requiring insurers to file new rates that complied with legislative caps.[12]

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[11] G.L. c. 175, §113B, ¶5 and c. 175E, §4 (d) prohibit rating by age groups, except for the rate reduction for policyholders age sixty-five or above. Operators are, however, classified based on their years of driving experience.

[12] According to the June 1978 *Opinion, Findings and Decision on the Operation of Competition Among Motor Vehicle Insurers,* the decision allowing competition in 1977 resulted in rate increases ranging between 50 and 100 percent for young and for urban drivers.

Participants at the hearing this year recognized that instituting full competition for 1977 produced unacceptable results.

The fixed and established rates incorporate certain cross-subsidies that result in lower rates for less experienced and urban drivers. As participants at the hearing acknowledge, such cross-subsidies, in general, reflect public policy. Removal of cross-subsidies contributed to the steep rate increases in 1977. The AG testified that the conditions that led to those increases have not changed, and that shifting to competition at this time could again result in disruptive rate increases for urban drivers, with minimal reductions to those in other communities.[13] He asserted that any competitive system should include a subsidization and cost-sharing mechanism to protect urban policyholders from rate shock, and that until such a mechanism is in place, competition should not be implemented. The SRB, while it supports a transition to a more competitive rating system, also takes the position that greater competitiveness should be accompanied by appropriate safeguards to ensure that rates do not increase dramatically. Plymouth Rock commented on the importance of avoiding high rate increases, particularly in the current economy, and the possibility that such increases would lead to more uninsured operators.

For the first time in many years, the hearing on competition in motor vehicle insurance generated extensive discussion and thoughtful submissions, both on the ultimate goals of a competitive system and approaches to achieving those goals. Those presentations demonstrated a general consensus that a move to a fully competitive market must be done through a controlled, gradual, phased-in process. At the same time, they did not take into account the current statutory constraints upon the Commissioner's authority to address effectively what is viewed as a complex, long-range process.

The responses to the June 20 Order do not persuade me to adopt any of the hybrid proposals that would combine some aspects of competitive rating under c. 175E with some facets of the fix-and establish procedures set out in c. 175, §113B. No participant argues that either statutory scheme offers direct, clear support for the concept of flexband rating. Assertions that authority to set rates as a range can be implied are countered by arguments that the statutory language prohibits that approach. The argument that a

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[13] The AG testified that urban areas account for a disproportionately large percentage of claims dollars from all types of losses, and that this disproportion has changed little since 1988. Further, he stated, the disparity in claims experience among some urban and suburban communities may be even larger now that it was in 1977, when full competition was briefly tried.

decision setting rates within flexbands "might" be upheld on appeal suggests that such a decision may not be firmly grounded in the law. Neither policyholders nor insurers will benefit from a decision whose legal underpinnings are questionable, as uncertainty in private passenger insurance rates leads to economic instability for sellers and purchasers.

No participant in this year's hearing voiced support for a return to full-blown competition in 2004. Despite general agreement that competition benefits consumers, no proposal has been developed that addresses the concerns raised at this hearing about the potential consequences of a move to full competition. No one presented any program for a competitive system that would incorporate current or alternative mechanisms to preserve subsidies and cost sharing. On consideration of the written submissions and the statements made at the hearings, I conclude that a move to full competitive rating in 2004 is not advisable. I further conclude that the current statutory scheme provides no affirmative support for partial competition in the form of flexbanding.

The memoranda filed in this case also do not persuade me that it is practicable, under the current statutory scheme, to initiate a bifurcated ratesetting process under which selected coverages offered under the standard policy would be excluded from the fix-and-establish procedure. Nothing on the record indicates that there is even, as a starting point, agreement on what is a "kind, subdivision or class of insurance."[14] Even if c. 175E, §5 were interpreted to permit me to consider the effect of competition for particular territories, kinds, subdivisions or classes of insurance, no finding on the insufficiency or conduct of competition can be made absent support from an evidentiary record. No evidence was presented at the hearing on the potential effect of rates filed pursuant to c. 175E on any territory, kind, subdivision or class of insurance. The record contains no submission on any cost sharing or cross-subsidy mechanisms that would ensure that rates for urban and inexperienced drivers would not be excessive. The reduction in price competition over the past few years lends further support to a finding that competition is insufficient to assure that rates would not be excessive.[15]

The potential difficulties in developing a hybrid system of partial rate setting were extensively discussed in the August 1977 *Supplementary Opinion and Decision on the*

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[14] The sole decision on this issue characterized Private Passenger and Commercial as separate classes of insurance, and allowed competitive rating for the latter class.

[15] I recognize that complex issues underlie the reduction in price competition in recent years.

Operation of Competition Among Motor Vehicle Insurers, p. 4. No participant in this year's proceeding presented any proposal for ratemaking that would address the problems identified in 1977. No person suggested that, since that time, changing conditions have rendered those concerns irrelevant. Partial ratesetting, even if were legally permissible and deemed theoretically desirable, should not be adopted without appropriate consideration for the interaction between the fix-and-establish procedures and competitive pricing.

Competition in the market for motor vehicle insurance, however, is not prohibited by a finding that existing competition is insufficient to assure that rates will not be excessive. History shows that individual insurance companies have the capacity to develop options including, but not limited to, riders or endorsements to the standard Massachusetts automobile policy that have the potential to increase competition. Fixed-and-established rates are based on examination of data aggregating the experience of the industry as a whole, and incorporate allowances for losses, expenses and profits. Those allowances do not necessarily reflect the experience of any individual company, and provisions in the rates for various items may exceed or understate the actual costs of those items for any particular company. Chapter 175, §113B provides for price competition in the form of rate deviations and endorsements that reflect savings through reduced costs.[16] Insurers may also compete through group discounts allowed under G.L. c. 175, §193R and adjustments to finance plans filed pursuant to G.L. c. 175, §193B. However, the decision to engage in price and policy form competition lies solely with the individual insurer. Insurers have always had the opportunity to market their products by promoting the level of service that they offer. I find that creating a complaint database would assist consumers in making purchasing decisions based on service.

Furthermore, the fix and establish procedure itself is not immutable. The familiar concepts supporting consistency in ratemaking and the principle that the proponents of new methodologies must justify their superiority do not prevent proposals to adjust the ratesetting process to improve accuracy or to address perceived inequities in the results. Concerns about the extent or continued desirability of some or any of the cross-subsidies now in place can be addressed in the section of the rate hearing that addresses relativities.

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[16] The option to compete on the basis for price is available, through deviations, for particular forms of coverage.

Similarly, recommendations about the methodology for determining the company expense ratio in the rates are better addressed during the course of a rate hearing, where they can be fully reviewed by parties to the case.

Statements made at the hearing indicate that participants representing many constituencies generally share two goals: reform of the residual market and movement toward competitive pricing. Some perceive that changes to the residual market are critical to a shift to a truly competitive market, but much of the industry urges that, concurrently with efforts to reform the residual market, steps be taken to enable greater competition in the market as a whole. The variety of proposals suggests that there is no single way to achieve either goal. Massachusetts motor vehicle insurance reflects an accretion over time of statutes, decisions interpreting those statutes, regulations, and public policy determinations. Proposals for eliminating such alleged barriers to competition as the "take all comers" law would require statutory changes. Other changes might be achieved through regulatory revision or a reconsideration of public policy. Even when there is consensus for change, successful implementation requires careful consideration of the overall effect of any particular proposal. Debates may rage over wide-reaching reform proposals, while piecemeal approaches may evade dealing with some basic issues. Several participants recognized the potential complexities of combining some aspects of the fix-and-establish system with rates filed pursuant to c. 175E, including the effect on policies ceded to the residual market, the effect on competition for certain classes of insureds, and the difficulties of developing and maintaining separate financial data relating to particular coverages. No person, however, offered a well thought out plan to address these questions. If reform is to be successful, careful and detailed advance planning is necessary.

For over seventy-five years, the Massachusetts legislature has been involved in motor vehicle insurance issues. G.L. c. 175, §113B, first enacted in 1925, and amended thereafter with some frequency, is a testimonial to continuous legislative concern that motor vehicle insurance rates not be excessive, inadequate or unfairly discriminatory. In addition, the legislature has demonstrated an interest in ensuring that premiums for individual policyholders are based in part on their driving records. At least since 1975, merit rating plans incorporated into c. 175, §113B look at the driving history of individual

operators, increasing premiums for those who present higher risks and reducing them for operators with clean driving records. The goals of industry-wide rate setting under the fix-and-establish system are to produce rates that are reasonable, adequate, just and non-discriminatory for operators as a group and which, as applied to individuals through the Safe Driver Insurance Plan, balance the general rates for classes of drivers with consideration of individual driving records.

Proposals to restructure or replace the current system for developing statewide motor vehicle insurance rates, as well as proposals to increase competition within the current system, affect all consumers and insurers. Adoption of a flexbanding approach to rating could effect a fundamental change in the way in which rates are applied to individual policyholders. I find, therefore, that it is appropriate to give the legislature an opportunity to review this issue, to evaluate the implications of flexbanding for public policy, and to make appropriate statutory changes to clarify that this approach to ratesetting or rate approval is acceptable. Once a framework is established, consideration will be given to developing ratemaking procedures that comply with any legislative directives.

For these reasons, and based on the record of this proceeding, I find that present conditions are such that competition, if implemented in 2004, would be insufficient to assure that rates will not be excessive, and might be so conducted as to be destructive of competition. Therefore, with respect to the private passenger class, the procedures set forth in G.L. c. 175, whereby the Commissioner fixes and establishes rates, and insurers may apply to deviate from those rates, will continue to be used for all coverages for calendar year 2004.

I am sympathetic to the claim that the fix-and-establish ratesetting process presents a barrier to entry into the private passenger automobile insurance marketplace, thus limiting insurance options for consumers. However, the presentations made in this proceeding do not persuade me that the current statutory scheme allows for a slow, controlled introduction of competition. At the same time, there appears to be consensus that only a gradual move toward full competition will prevent the rate instability that was experienced during the 1977 experiment with competitive rating.

V. Other Issues

Two other issues raised in the course of this proceeding require separate discussion: optional endorsements to the standard policy and reform of the residual market.

A. Optional Endorsements

With respect to optional endorsements, the industry seeks permission to offer consumers products that complement the coverages available under the standard policy and to provide that enhanced coverage in exchange for additional premium. Insurers propose to follow a so-called file and use process for the endorsements and the rates associated with them. This is the first time, in the context of the competition hearing, that the Commissioner has been provided with broad-based discussion of the issues related to optional endorsements for which additional premium would be charged, *i.e.*, "added premium optional endorsements," or "APOEs."[17] None of the written submissions argues that current statutes absolutely prohibit insurers from offering APOEs that would provide coverage for risks that differ from those covered in the standard policy.[18] As noted above, the point has been made that such endorsements are a permissible step that would enhance competition in the marketplace.

Concerns have been raised in this proceeding about the regulatory process applicable to APOEs. The SRB notes that case by case decisions must be made to determine whether proposed endorsements are consistent with the other provisions of Massachusetts law relating to motor vehicle insurance. The AG has raised questions about the benefits APOEs will offer consumers. Both the AG and the SRB stress that sales of APOEs would affect the data that is used to fix-and-establish private passenger insurance rates, and that provisions must be made to ensure that such data is not compromised.

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[17] In 2001, an informational hearing was held on the process for approving or disapproving endorsements and rate filings in the area of private passenger automobile insurance.

[18] Because such endorsements would add coverages for additional premium, they do not fall within the class of endorsements that, so long as the Commissioner decides to fix and establish rates, are rated under that system. G.L. c. 175, §113B, ¶7 allows the Commissioner to provide for appropriate reductions in premium charges for relevant coverages if "any optional policy provision will result in savings through reduced costs."

Despite apparent consensus on the legal status of APOEs, the record indicates that there are considerable discrepancies between the insurers' position on the desired method for achieving their goal and the oversight that regulators recommend. Even if APOEs are legally permissible, neither consumers nor the industry will be well served if there are no specific standards for evaluating APOEs and no clear review process in place.[19] I have therefore concluded that no final decision should be made at this time on the question of allowing APOEs until there is agreement on the appropriate regulatory approach. It is essential that rate filings made pursuant to c. 175E be evaluated under consistent standards.

Postponing a decision on APOEs at this time will potentially achieve three goals. First, it will ensure that the industry has an opportunity to review the concerns that have been expressed in the course of this hearing and to determine that it can comply with criteria designed to address them. Second, it will allow review and discussion of industry proposals by interested parties. Finally, it may result in presentation to the Commissioner of a proposal for regulatory review that resolves the concerns raised in this proceeding.

I invite comment on procedures relating to such filings including, but not limited to, such matters as the issues that should be considered in evaluating various types of APOEs and appropriate procedures for maintaining separate accounting systems. The following observations should provide some guidance for developing an appropriate approach. First, APOEs to the standard policy are considered motor vehicle insurance, and must comply with all Massachusetts statutes and regulations relating to private passenger automobile insurance.[20] Second, the Commissioner's standard for review of all endorsements includes determinations on compliance both with Massachusetts law and with considerations of public policy. Insurers will be expected to demonstrate that proposed optional upward endorsements will benefit consumers. *See*, *Decision on the Commissioner's Authority to Approve an Optional Endorsement*, R96-39, at 11. Third, rate filings under c. 175E, must comply with the mandate that such rates shall not be excessive or inadequate, nor shall they be unfairly discriminatory, as well as with the other standards set forth in that chapter. Fourth, provisions must be made to ensure that insurers segregate all data relating to premiums, losses and expenses and profits associated

[19] I note that 211 CMR 76.00, the regulation promulgated to implement c. 175E, is no longer in place.
[20] These include, but are not necessarily limited to, G.L. c. 90, c. 175, c.175A, and c. 175E.

with any APOEs that they file from the data that relates to the standard motor vehicle policy. It is essential that no data relating to APOEs be commingled with data that will be used in setting rates for coverages offered under the standard policy. Insurers must demonstrate that separate accounting systems are in place before seeking approval of APOEs.

As noted above, three approaches to competition are possible within the fix-and-establish system. Although the Commissioner cannot require insurers to engage in any particular form of competition, she can help foster a regulatory climate that fosters competitive activities. Well-established procedures for approving price competition through downward rate deviations and group discounts are now in place. Consumers will benefit as well from the implementation of procedures that are designed to encourage and support competition in product and service. To support those particular forms of competition, I am ordering interested parties to submit proposals that address: 1) development of a complaint database designed to assist consumers in evaluating insurance companies based on service; and 2) recommended standards and procedures for reviewing APOEs and the rates associated with them.

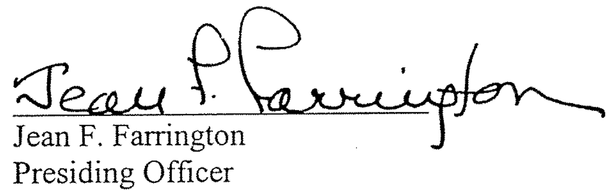
The State Rating Bureau shall promptly convene meetings with interested parties, who are encouraged to work together to develop joint submissions on these matters. Initial proposals shall be submitted by September 15, 2003.

B. CAR Reform

Although reform of the residual market is peripheral to the focus of this proceeding, the record amply demonstrates the connection between that market and insurers' interest in competing for private passenger automobile insurance business. Discussions with interested parties have been underway for some time. CAR itself has been engaged in addressing a number of issues raised by its members. The Massachusetts private passenger automobile insurance system is not comprised of discrete parts that can easily be separated from each other. Any adjustments made to one aspect reverberate throughout the entire system. Consequently, those adjustments must be well thought out and carefully implemented. At this time, the most prudent course of action is to focus our concerted energy and attention on improving CAR and the residual market, with the simultaneous goals of making the CAR rules more transparent and uniform and, for

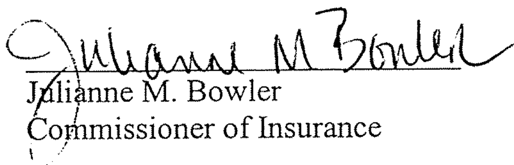
consumers, minimizing marketplace disruption. Some issues relating to the residual market which are currently under discussion are also addressed in G.L. c. 175, §113H, the CAR enabling legislation, and may require legislative solutions. As part of her authority over CAR, the Commissioner will continue to oversee this process.

This decision has been filed this 8 th day of August 2003 in the office of the Commissioner of Insurance and with the Secretary of State as a public document. Any party aggrieved by this decision may, within twenty days, file a petition for review in the Supreme Judicial Court for Suffolk County.



Jean F. Farrington
Presiding Officer

Affirmed:



Julianne M. Bowler
Commissioner of Insurance