In The Matter Of:

Commonwealth of Massachusetts
Division of Insurance, MPIUA Rate Filings

FAIR Plan Hearing, Volume II
February 28, 2012
Docket No. R2011-02

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COMMONWEALTH OF MASSACHUSETTS
OFFICE OF CONSUMER AFFAIRS AND BUSINESS REGULATION
DIVISION OF INSURANCE
DOCKET NO. R2011-02

HEARING RE:
Application of the Massachusetts Property Insurance Underwriting Association for Approval of Rate Filings Including Rate, Rule and Form Revisions for Homeowners Multi-Peril Insurance, and Rate and Rule Revisions for Dwelling Fire and Extended Coverage and Commercial Fire and Allied Lines Insurance, Each Filing to be Effective on and after December 31, 2011, held at the Division of Insurance, 1000 Washington Street, Boston, Massachusetts, on Tuesday, February 28, 2012, commencing at 10:05 a.m.

BEFORE: Jean F. Farrington, Presiding Officer
Stephen M. Sumner, Presiding Officer

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P R O C E E D I N G S

PRESIDING OFFICER FARRINGTON: Good morning. Today is February 28, 2012, and this is our second day of hearings in Docket No. R2011-02, the rate hearings on the FAIR Plan.

Anything we need to discuss before proceeding with Dr. Derrig?

MR. MEYER: Yes, Madam Hearing Office. Yesterday morning you asked the FAIR Plan to mark everything that it was going to mark ahead of time, whether or not it related to yesterday's witness.

I did not have with me yesterday but have with me this morning a November 23rd document. It's not relevant to Dr. Derrig. It's relevant to Mr. Ericksen, who has not yet testified. It's his ASOP 38 compliance. So I would like to mark that at this time, just to be in compliance with what you asked us to do. If that could be marked as the next numbered exhibit, please.

PRESIDING OFFICER FARRINGTON: It will be Exhibit 6. Any objection to that?

MR. LEIGHT: No objection.

(Document marked as Exhibit 6 in evidence)

MR. KLIBANER: Madam Hearing Officer, we wanted to point out that, in the MPIUA filing, testimony of Kathy Barnes is incorporated by reference on Page 8, I believe, of Exhibit 2. We don't have an objection to that, but we would like to offer the cross of her testimony from 2009 as part of the record in this hearing as well.

I've already distributed the transcript of that cross-examination of Kathy Barnes from 2009, and I have copies for the Hearing Officers as well.

PRESIDING OFFICER FARRINGTON: All right. So you've got both her testimony and the cross-examination; is that correct?

MR. KLIBANER: We have just her cross-examination here. It was incorporated into the filing by reference.

PRESIDING OFFICER FARRINGTON: What page was that on?

MR. KLIBANER: I believe it was on Page 8.

MR. MEYER: It's in the Introduction Executive Summary. In any case, Madam Hearing Officer, we have no objection to this transcript being marked as an exhibit.

PRESIDING OFFICER FARRINGTON: All right.

So you make this reference on Page 8, but you've not actually included a copy of her testimony; is that correct?

MR. MEYER: No, we have not. But because the AG is putting in the cross, we probably will provide you a copy, just as a matter of convenience. In any case, I do not object to the transcript being marked as an exhibit now.

PRESIDING OFFICER FARRINGTON: So this will be Exhibit 7.

(Document marked as Exhibit 7 in evidence)

PRESIDING OFFICER FARRINGTON: Are there any other preliminary matters?

MR. MEYER: Nothing.

PRESIDING OFFICER FARRINGTON: Dr. Derrig.

RICHARD A. DERRIG, Sworn

DIRECT EXAMINATION

BY MR. MEYER:

Q. Please state your name for the record.

A. Richard A. Derrig.

Q. And your current office address, Dr. Derrig?

A. My current office address is 91 Fosdyke Street, Providence, Rhode Island 02906.

Q. And your current position, sir?

A. I'm president of Opal Consulting LLC and Visiting Professor of Risk Insurance and Health Care Management at Temple University.

Q. I show you a document, sir, which is part of Exhibit 2, the FAIR Plan's filing in this case, starting at Bates stamped Page 1043 and continuing through Bates stamped Page 1191 and ask you if that is your testimony in this case, sir.

A. Yes, it is.

Q. Was that prepared by you or by someone working under your supervision and control?

A. Yes.

Q. And are the matters contained therein true and accurate, to the best of your knowledge and belief?

A. Yes, they are.

Q. I also show you another document entitled "Exhibit 4," which are some corrected pages. Did you prepare those, or were they prepared under your supervision and control?

A. I prepared these.

Q. And are the matters described in those corrected pages true and accurate, to the best of your knowledge and belief?

A. Yes.

Q. Could you just very briefly explain for the record why those corrected pages were generated.

A. The brief version is that I used some data that was provided by ISO, and ISO created their section of the filing in three pieces according to the lines of insurance.

The smallest piece, which is commercial property, was the last to be compiled, and I had to anticipate at least one expected value while I prepared my profit section. I had to guess at one number -- I came very close -- and when the actual number came in, I substituted that. The correction made very little difference. There was also one arithmetic mistake that was also minor and all on commercial property.

So those two corrections were made, and that's what's in Exhibit 4. Because the final rate filing contains a profit provision to one decimal place, the correction made no difference whatsoever.

Q. Do you have any corrections in addition to those contained in Exhibit 4 to what is contained in

Exhibit 2, the initial filing?
A. **No.**
MR. MEYER: Thank you. The witness is available for cross-examination.

CROSS EXAMINATION

BY MS. MORAN:

Q. Good morning, Dr. Derrig.
A. Good morning.
Q. My name is Mary Lou Moran, and I'm representing the State Rating Bureau in this proceeding. I have a few questions.
A. Sure.
Q. On Page 1058 of the filing you state that "The members of the MPIUA bear the risk of losses from hurricanes that exceed the reinsurance attachment point of $200 million and are not covered by the reinsurance treaty." You further state that "Members act as reinsurers for these expected losses and allocate an appropriate level of capital to underwrite these expected losses."
Is it your belief that Massachusetts property insurers specifically identify surplus for the purpose of responding to the MPIUA obligations?
A. I'm not sure I understand your question.

Let me at least say this: There is an equivalent, literally, in this portion of the filing between surplus, as it's used in the financial statement and the policyholder surplus that is usual for an insurance company, and members equity, which is the title of what that similar financial item is for the FAIR Plan. So they are equivalent concepts.
I treat members equity as surplus within the underwriting profit model, because that's what's available to the FAIR Plan to run their business right now. But the voluntary companies are the owners of that.
Q. Dr. Derrig, the individual member companies of the MPIUA, if you know, do those companies have a separate account earmarked as surplus for the MPIUA?
A. I don't know.
Q. For the purposes of this statement, then, would it be fair to say that Massachusetts property insurers understand that they're responsible to pay any losses that the MPIUA does not have the ability to pay, regardless of their current earnings or surplus position?
A. Well, I believe they certainly understand the fact that they are responsible in total for

losses over and above what's planned for in their rates. And they have two avenues to do it. One avenue is that the members equity that sits with the FAIR Plan and is owned by the companies is first used to pay excess, and then there is the assessment process, if that's insufficient. What they have on their own books, I don't know.
Q. Is it reasonable to assume that this potential assessment against the private property insurance companies may be factored in the premiums those companies charge the policyholders that they insure directly? And we're talking about companies that have never been members of the MPIUA.
A. Would you mean an expected assessment beyond what the FAIR Plan retains in their members equity?
Q. Just the rate itself. I'm sorry, would you give me one moment. I apologize.
Dr. Derrig, what I'm attempting to ask you, and not doing as well as we hoped, the policies that one of the member companies of the MPIUA sell to their insureds, do those policy prices, premiums, contain a cost for the amount that that company may be assessed by the MPIUA membership?

A. I don't know whether they do or not.
Q. The MPIUA has filed a fairly large program of reinsurance for the benefit of the MPIUA policyholders. The SRB has prepared this exhibit based on Mr. Wackerman's testimony, which summarizes the reinsurance placement for the period July 1, 2011, through June 30, 2012.
As you can see, reinsurance is provided -- all right. Dr. Derrig, I'm going to come back to this question.
On Page 1058 of the filing, you note that members equity for MPIUA was $247.2 million as of September 30, 2010. Is it your opinion that this level of equity would be sufficient to cover the MPIUA's catastrophic exposure for losses that are less than $1.2 billion?
A. Do you mean with or without the reinsurance?
Q. Let me -- I should have given you more time. Let me just repeat the question. On Page 1058 of the filing, you note that the members equity for the MPIUA was $247.2 million as of September 30, 2010.
A. Yes.

Q. Is it your opinion that this level of equity would be sufficient to cover the MPIUA's catastrophic exposure for losses that are less than $1.2 billion?

A. I would think so, given the reinsurance program they have this year.

Q. You position the MPIUA as a stand-alone company whose company members function as its reinsurers. Is there any charge to the MPIUA policyholders for the reinsurance the MPIUA's member companies provide if an insured loss exceeds $1.2 billion?

THE WITNESS: Could you read that back.

(Question read)

A. I'm not sure that I would phrase it as the reinsurers, the member companies are reinsurers. I'm modeling the FAIR Plan as a company, and I view the voluntary insurers as the investors in this kind of a model.

So in the real world, the investors in, let's say, a company, a stock company, would not be responsible if they exhaust their entire capital. They would be bankrupt, and bankruptcy would proceed.

In our situation, because there is a statutory assessment that's possible from the FAIR Plan to the voluntary companies, they are perhaps an analogy of being like a reinsurer for all those catastrophic losses that are not covered by either the members equity, because you assume that that's not used, expected to be used, and excess of the reinsurance.

And since the reinsurance this year is virtually complete from the attachment point of $200 million to $1.2 billion, with only a little bit exposure, the voluntary companies would be responsible for catastrophic losses in excess of the reinsurance program and in excess of what the members equity already has, excess of the attachment point.

Q. Would it be fair to say that you believe the only thing that distinguishes the MPIUA from a private company is its statutory charter?

A. That's one difference, yes.

Q. If a private property insurance company had reinsurance for catastrophic loss in addition to its surplus, and a single loss wiped out both, what would happen to the policyholders of that company?

A. I'm not sure, because I don't know what the Massachusetts statutory scheme might be for, like, guarantee funds and so forth in this case.

Q. On Page 1158 of the filing, you provide an exhibit that displays the calculations underlying the leverage ratio used in your profit model. In particular I would like to draw your attention to Column 5, which is labeled, "Surplus." These values are from MPIUA year-ending September 30th financial statements, correct?

A. Correct.

Q. The surplus shown in Column 5 has increased significantly since 2005, from roughly $57 million to $247 million in 2010. Would you agree with this statement, that increases in surplus are primarily generated through underwriting profits, investment gains and member assessments or distributions?

A. I'm not sure what you mean by the last piece, member distributions.

Q. If assessments were made to the members or if profits were distributed to the members? That's what I'm considering under distributions.

A. Okay. I think -- well, since I use member equity as calculated in their financial statements

as of September 30th of each year, that's what I assume is available to the FAIR Plan to pay without assessment.

In particular, the voluntary companies in total own this what I've labeled "Surplus," but which is really members equity. And whether they have it on their own books or whether they have it here is a matter of convenience. It still would require some kind of ability to pay in excess of the expected.

So in my modeling I assume that, in a sense, there is no assessment to the underlying member companies, because what they've retained as member equity is sufficient. And so my estimate of going forward of $280 million is just that.

Q. Dr. Derrig, if you could look at Column 5 for me on 1158, between 2006 and 2010, you noted the changes in surplus. What I am asking is, can you tell me exactly what caused this change in surplus each year?

A. Well, I expect that it's the retention by the FAIR Plan in the members equity account for what was gained in each of the years, rather than, let's say, returning the, quote, profit back to each of

the member companies and then assessing it again. So it's a matter of convenience, at least, to accumulate it within the FAIR Plan and deploy that in underwriting the FAIR Plan's exposures.

I don't know, you know, the particulars of what the assessments and distributions are. I do know that for the accounting purposes, the FAIR Plan reports back to every one of the underlying companies what their profit or loss is for the year, even though it may not be distributed.

Q. Dr. Derrig, would underwriting profits be one potential factor in an increase in surplus?

A. Sure.

Q. How about investment gains? Would investment gains perhaps cause an increase in surplus?

A. Yes. Probably.

Q. And, say, a member assessment. Would that -- if members were assessed, might that show as a gain in surplus?

A. Well, that would depend on whether or not it was an assessment used to pay losses that year. Then it would not flow into surplus.

Q. But if it hadn't been needed to be accessed

immediately and used, then it might be reflected in a gain in surplus, if there was such a thing --

A. Yes, if there was such a thing.

Q. -- just for argument's sake.

I would like to be using an exhibit in the next question, Dr. Derrig, and I've already passed out the exhibit to everyone.

MS. MORAN: I would ask that it be marked now for identification, and I believe it's Exhibit 8.

PRESIDING OFFICER FARRINGTON: There are two sheets here. Are they separate exhibits?

MS. MORAN: They are going to be separate exhibits.

PRESIDING OFFICER FARRINGTON: So which one do you wish to have marked as 8?

MS. MORAN: I'm referring to the Column 1, labeled as "Members Equity." That would be Exhibit 8.

MR. MEYER: No objection.

PRESIDING OFFICER FARRINGTON: Is there an extra copy?

(Document marked as Exhibit 8 in evidence)

BY MS. MORAN:

Q. Dr. Derrig, you have an exhibit that's prepared by the SRB that provides information from the MPIUA's fiscal year income statement for 2006 through 2010. You'll note that the values in Column 1 of this exhibit are the same as the values shown on Page 1158 of the filing, but for rounding. Column 2 calculates the changes in surplus from one year to the next. Do you see that, Dr. Derrig?

A. Yes.

Q. Moving to Columns 3 and 4, Columns 3 and 4 reflect the net underwriting gain or loss and income from other sources as they appear on the same financial statement. Do you see?

A. Columns 4 and 5. Right.

Q. These two values, combined, represent net income to the MPIUA. Column 6 is the ratio of net income over the total change in surplus.

Assuming the SRB's calculations are correct, would it be reasonable to conclude that the majority of the recent changes in MPIUA's surplus are attributable to insurance operations, rather than equity adjustments such as changes in nonadmitted assets, changes in accounting

principles, changes in pension obligations or member company assessments or distributions?

A. I really don't know, with all that list of things. My assumption underlying my portion is that the FAIR Plan is not distributing but rather retaining members equity. That's all I use. So those other things that are in the financial statements, I have not compared one year to the next or anything else.

Q. Dr. Derrig, the majority of the changes would be caused by underwriting operations then or investment gains?

A. Well, let me answer your question this way: Assuming that there were no assessments and distributions, then the gain would be from underwriting, including investment income.

Q. Dr. Derrig, the next question involves an exhibit, and this exhibit begins with Column 1, "Premiums Earned." Column 2 is "Reinsurance Premium Paid."

MS. MORAN: I'm going to ask that this exhibit be marked for identification, and I believe it is Exhibit 9.

MR. MEYER: No objection.

(Document marked as Exhibit 9 in evidence)

Q. Dr. Derrig, looking at Exhibit 9 that was prepared by the SRB, this exhibit uses figures from the same financial statements that were used in the previous SRB exhibit.

In Column 1 of the exhibit that we're looking at now, Exhibit 9, we show the earned premiums for the MPIUA in each of the fiscal years from 2006 through 2010. Column 2 displays reinsurance premiums paid by the MPIUA, and Column 3 displays what the MPIUA refers to as net earned premium, which is equal to earned premium, minus reinsurance premium. Are we together so far, Dr. Derrig, on this?

A. So the actual premium is Column 2 plus Column 3?

Q. That's correct. Do you know why the MPIUA would restate the premiums in its financial statements to exclude reinsurance premium payments, rather than to recognize it as an expense?

A. No.

Q. We're finished with that exhibit, Dr. Derrig. Thank you.

In the profit model that you offer in this filing, the model recognizes the cost of reinsurance as an expense, does it not?

A. Yes.

Q. Now, based on the discussion we had earlier about the changes in the MPIUA surplus, we discovered that the changes are due largely -- I think we came close to discovering that the changes were due to increases in underwriting and other income?

A. Correct.

Q. As we can see from the exhibit, the underwriting income was earned even though the MPIUA paid a sizeable premium to provide reinsurance protection for its policyholders. Would you agree with the observation that, over the past four or five years, the protection provided by MPIUA's reinsurance program has been fully funded by premiums collected by its policyholders?

A. That, I cannot -- I don't know, because I don't know the relationship to the actual premiums charged for the reinsurance. I mean, it certainly looks like, from your numbers, that it is, but I don't know whether that's the same as what a fully -- set of rates would generate.

Q. Dr. Derrig, Dr. Horn is joining me. I wear them out fast, so we have to keep changing people beside me. I hope you'll understand.

A. Fine.

Q. Dr. Derrig, do you base your opinion regarding the profit provision on the similarities in terms of -- in the filing on Page 1057, you talk about the similarities between the MPIUA and the voluntary market, and --

A. Excuse me. What page?

Q. 1057, back in the very beginning, under the introduction for the underwriting profit component. And actually, this would be -- I believe this was one of the pages that Attorney Meyer put in as a revision. So we probably should have this on the record as Page 1057R --

A. Oh, right. I'm sorry.

Q. -- that was marked as part of Exhibit 4.

A. Correct.

Q. Dr. Derrig, in your testimony in that area, you talk about the similarities, as I said, between the MPIUA and its business activities, as compared to those of the voluntary -- the insurers in the voluntary market, and you talk about such activities as accepting applications, paying claims, issuing policies, et cetera.

A. Right.

Q. Do you base your opinion regarding -- if I may, your opinion, I believe, as so stated, is that you believe that a profit provision is appropriate for the MPIUA, including a provision --

A. Yes.

Q. And do you base your opinion regarding the appropriateness of the profit provision on the similarities in terms of business activities between the MPIUA and voluntary market insurers?

A. Yes. At least in part, yes.

Q. And in part are there other -- can you expand on that.

A. Well, the notion that there's a members equity at risk to the FAIR Plan writings, plus these eight different kinds of functions. Those two together mimic an ordinary insurance company for assessing the reasonableness and modeling of underwriting profit.

Q. And also, according to your testimony I think on the same page that we're on, 1057 Revised,

you indicated that you derived the MPIUA underwriting profit provision included in the filing using an internal rate of return model. And I believe, and I'm asking you to expound on this, an internal rate of return model, that's something that other businesses use to generate a profit component, is that true, not just the insurance business?
A. Yes.
Q. And the IRR model, if you will, that you use to calculate the profit provision for an insurer generally, how would that differ from the IRR model that you might use to derive a profit component for another type of business, say even like a third-party administrator, for example?
A. Well, it would differ in the assemblage of the cash flows, such as the cash flows of premiums and losses and so forth, expected. It would have to reflect all the details that are important for estimating some kind of profit margin. That's what we're talking about.
So all the details would be different, but the general notion of the cash flows and getting a -- solving for one piece of it, in our case premiums, would be roughly the same.

Q. Does the degree of risk, say, that the business that we're speaking of involves influence the type of model that you would use or how you would calculate the model? Say, again, for instance, looking at the insurance business, inherently at least there would be an argument that there's a greater risk there of loss or the need for money than, let's say, the third-party administrator type situation, where certainly bad business decisions, et cetera, could cause them to perhaps not have a great year, but the real risk of loss would certainly be greater in an insurance setting than in another type of less risky business. Does the degree of risk figure into your calculation?
A. You included in your question the comparison to a less risky business. So if it's less risky, presumably the calculations for the expected profit would be lower. I mean, we're trying to value risk, the risk of loss. That's what the company is valuing.
Q. Could we look at Page 1181 in your filing.
A. Yes.
Q. At the top of the page, Dr. Derrig, after the section numbered 2.15, there's a definition of

underwriting profit provision. Do you see that?
A. Yes.
Q. Would you please read that definition for the record.
A. This is Item 2.15, "Underwriting Profit Provision," and it's definition is "The provision for underwriting profit in the actuarially developed rate, typically expressed as a percentage of the rate."
Q. And that definition, sir, is what you followed in calculating the profit component for the MPIUA?
A. Well, I mean, that one line doesn't really say much of anything. Linguistically I don't think you're supposed to define a term in terms of the exact term. It shouldn't be on both sides. But it's just explaining that underwriting profit provision is part of an actuarially developed rate.
Q. Now, if you could turn to Page 1180 in the filing, turn back, I guess, to 1180, there's a definition of contingency provision. I think it is 2.2.
A. Correct.
Q. Could you also read that definition.

A. 2.2, "Contingency Provision" is "A provision for the expected differences, if any, between the estimated costs and the average actual costs that cannot be eliminated by changes in other components of the ratemaking process."
Q. And finally, Dr. Derrig, I'm going to try your patience and ask you to move to Page 1182, under 3.7. It's also labeled, "Contingency Provision."
A. Yes. That's 3.7?
Q. Correct, sir.
A. Yes.
Q. And could you read that for the record, please.
A. 3.7, "Contingency provision. The actuary should include a contingency provision if the assumptions used in the ratemaking process produce cost estimates that are not expected to equal average actual costs, and if this difference cannot be eliminated by changes in other components of the ratemaking process."
Q. Thank you, Dr. Derrig. Would you agree that the principal contingency of the MPIUA is the difference between what a hurricane loss could be

and what the average annual loss from a hurricane is?
THE WITNESS: Can you read that.
(Question read)
A. No. I don't think so.
Q. There's no separate contingency provision in the MPIUA filing, is there?
A. No, there is not.
Q. And is that because the MPIUA members equity, combined with the reinsurance program, already takes into account the capital needed to fund the losses from a hurricane?
A. No, that's not my understanding.
Q. And is the cost of the uninsured portion of this contingency already reflected in the profit load calculated in your internal rate of return model?
A. No. We don't use a contingency provision at all.
Q. Dr. Derrig, you said that the MPIUA model does not contain a contingency provision; is that correct?
A. Right. I don't have a contingency provision at all.

Q. Does that differ from, on Page 1182, the contingency provision -- the statement that you read into the record? It's speaking to an actuary should include a contingency provision. Do you see that as a conflict, or no?
A. I mean, let's go back to 3.7. "Contingency Provision - The actuary should include a contingency provision if the assumptions used in the ratemaking process produce cost estimates that are not expected to equal average actual costs, and if this difference cannot be eliminated by changes in other components of the ratemaking process."
As far as I view this, I have assumed that the rest of the ratemaking process, the estimates of the reinsurance and the estimates of the actuarial component have eliminated any cost estimates that are not expected to equal actual costs.
And just a matter of some history, these contingency provisions go way back, probably to the '50s. And so they were always -- before the financial models, the provision was known as profit and contingency. That got eliminated in Massachusetts at least 20 years ago, because you assume that the actuaries that are involved are

doing a correct job of estimating actual costs. Otherwise the rate filings wouldn't mean as much.
So this hasn't been in Massachusetts at least for 20, 30 years.
Q. So going back to the statement in 3.7, the contingencies, you're saying that they are actually part -- they're covered by other parts of the filing --
A. No, they're not. There just isn't any. Because, if you read it, it says that someone has recognized that there is a place where they cannot estimate the cost, and so there's a contingency factor put in.
As far as I know, from looking at the filing, everything is estimated, and there is no -- I don't think there's a contingency anywhere.
Q. Would you agree that, for many years, there was no profit provision in the MPIUA rates?
A. I don't know how many years, but, yes. Before I made the original filing for profit, there was a zero.
Q. And keeping that in mind, in your view, if all the other components of the rate -- losses, expenses, et cetera -- were correct in those years

when there was no profit provision included in the rates -- that would be in a year in which the indicated profit provision was positive -- the rate would have had to be inadequate; is that correct?
A. That's correct.
Q. And do you know at what point the catastrophic model started being incorporated into the MPIUA rates?
A. No.
Q. And what about reinsurance? Do you know when a provision for reinsurance was first loaded -- the cost of reinsurance, into the rates?
A. Well, from your exhibit -- well, I can't tell from your exhibits.
Q. If you know, Doctor.
A. Well, from the testimony yesterday, reinsurance was allowed from 2006 on? And presumably -- I haven't looked at those filings, but I assume that once they had the reinsurance, the costs were put in.
Q. Dr. Derrig, could you explain the proportion of the MPIUA rates or what proportion of the MPIUA rates is currently constituted by reinsurance, catastrophe and profit?

A. What was that middle one?
Q. Catastrophe.
A. You mean non-reinsured catastrophic losses?
Q. Yes.
A. No. I don't know the total of those.
Q. Dr. Derrig, if we had a 100-year storm in the period subsequent to the creation of the FAIR Plan but prior to the loading of those three provisions into the rates that we just talked about, would the MPIUA have been able to pay its claims?
A. Well, that's really hard to say, because, you know, one in 100 years doesn't tell you what the dollars are. And if you want to go back to 2006, where the members equity was $56 million, period, I would just guess that they would be able to pay it without assessments.
Q. Without assessments. Thank you.
Dr. Derrig, do the members of the MPIUA join the association voluntarily, the companies that make up the members, and make an economic decision as to their investment into the MPIUA? Do they have control over those issues, the companies that are the members?
A. I don't know the legal ramifications of

this.
Q. But your understanding is?
A. My understanding is just simply that the members that are members are there, and how they get there, I don't know.
Q. Can the voluntary insurers in Massachusetts, if you know, assess their policyholders for losses in excess of their surplus and reinsurance coverage?
A. That -- I mean, I don't really know that legal point.
Q. On Page 1058 of the filing --
A. I don't seem to have 1058, because -- oh. There it is. Could you repeat the question.
Q. Could you tell us why you believe the cost of capital applies to the MPIUA.
A. Well, the simple reason is that there's capital at risk, and therefore the capital has a risk that's commensurate with what it's invested in. And it's invested in an insurance line, homeowners.
Q. And the members of the MPIUA, could they distribute all -- could the MPIUA, excuse me, distribute all of its surplus to its members and just operate on an assessment basis only for losses

in excess of the premium and investment income, at least theoretically?
A. No, not even theoretically. I mean, you would have to -- if you had no members equity?
Q. Right.
A. It's hard to believe that you would be able to operate and pay claims and have an efficient organization without having the equivalent of some surplus, in a generic sense. I suppose you could, you know, make it all accounting, but that would be probably more costly.
Q. On Page 1140, is the selected cost of capital based on gross or net of the reinsurance model?
A. Well, I'm not sure what gross and net means, but it is based on data for companies that generally include reinsurance, catastrophic reinsurance. So if that's gross or net, I don't know if it's applicable.
Q. Would you select a different cost of capital based on whether or not there was reinsurance in place for the MPIUA?
A. I guess I would have to think about it. If there were no reinsurance available to the MPIUA,

then they would be generally a more risky company than all of the companies that we use to get these estimates. So theoretically there would have to be an adjustment upward to the cost of capital.
Q. Could you tell us how you would determine the difference.
A. No. I think that would be very complicated, to take roughly 30 companies and try to unravel all of their reinsurance programs for homeowners. It would take a very large survey, let's say, to get some data like that.
Q. I'm going to ask you to look at Page 1157 again. It's the revised Page 1157 that's part of Exhibit 4. On that page, is the selected leverage ratio of reserves to surplus based on gross or net of the reinsurance model?
A. I'm sorry, what page was that again?
Q. 1157. Dr. Derrig, I'm going to ask you to look at -- my notes were wrong. It's Page 1057.
A. That's in the exhibit? 1057R in Exhibit 4?
Q. Dr. Derrig, you're probably going to believe we're testing your patience here, and maybe we are. It is -- the correct page should have been 1157. I apologize.

If you look at the very last paragraph, the beginning of the last paragraph on 1157, that's where the question is coming from.

A. **Okay.**

Q. And that is, is the selected leverage ratio of reserves based on a gross or net of the reinsurance model?

A. **Well, I think -- again, you know, net or gross is not really part of this. To the extent that the unearned premium reserve is in there and it contains some premium covering the reinsurance treaty at the close of the fiscal year, there's some portion of the reinsurance premium in the reserves.**

Q. Dr. Derrig, do you know what the return period associated with the $200 million retention is for the MPIUA?

A. **No, I don't, but I think that was in the testimony yesterday.**

Q. And what is the return period, if you know, associated with the top layer of reinsurance?

A. **I don't recall. I think that was in there yesterday too, Mr. Wackerman's testimony.**

Q. And one last. What is the return period, if you know, for the 1938 hurricane if it were to

occur today?

A. **I have no idea.**

MR. MORAN: Thank you, Dr. Derrig. I appreciate your patience.

MR. LEIGHT: Once again we're going to share the questioning, and Mr. Klibaner will start.

PRESIDING OFFICER FARRINGTON: Fine.

CROSS EXAMINATION

BY MR. KLIBANER:

Q. Good Morning, Dr. Derrig.

A. **Good morning.**

Q. My name is Alex Klibaner. I'm an Assistant Attorney General. I'll have some questions for you, and as you just heard, Mr. Leight will have some questions for you as well.

The IRR model in the filing assumes a federal tax rate of 35 percent; is that right?

A. **Yes.**

Q. In the model, who pays that tax rate?

A. **The voluntary companies.**

Q. Does the MPIUA notify the voluntary companies how much profit is attributable to those companies that they can pay those taxes?

A. **Yes. I believe there's an accounting by**

proportion of all the distribution of the members equity, changes in it, by voluntary company every year.

Q. Do you know whether those taxes by the voluntary companies are due on a quarterly basis or an annual basis?

A. **I have no idea.**

Q. Does the MPIUA notify the voluntary companies on an annual basis or a quarterly basis about what profit is attributable to them?

A. **I don't know whether it's annual or -- I assume that at least it's annual, if not more.**

Q. Are the taxes due by the voluntary companies, irrespective of whether any profit is actually distributed by the MPIUA to the voluntary companies?

A. **That's my understanding.**

Q. Do the MPIUA members actually pay 35 percent in federal taxes on the profit of the MPIUA?

A. **I don't know how they file their own taxes. I'm just estimating what the -- the income that would be passed on as the distribution of the profit is composed of pieces that are all taxed at 35 percent.**

Q. Have you checked any of the tax returns of any of the voluntary companies to see how they treat MPIUA profit?

A. **No, I didn't.**

Q. Do you know what the effective tax rate is of the member companies?

A. **No.**

Q. Do you know what the marginal tax rate is of the member companies?

A. **I mean, I'm assuming it's the corporate rate, 35 percent.**

Q. Does the corporate rate vary from company to company, or is it the same?

A. **Not the marginal rate.**

Q. So is it your understanding that, if a member company received an additional $100 as MPIUA profit, they would actually pay $35 to the federal government in taxes on that?

A. **Well, considering where the income is coming from, it comes from underwriting and investments. Underwriting is always at 35 percent, okay, whether it's profit or loss; and the investments that the FAIR Plan has are all fully taxable, interest and bonds, and they are always**

taxed at the marginal rate. So that's why -- you put the two pieces together. Each one is 35 percent. It's 35 percent for the total. That's where that number comes from.
Q. Is there anything that the MPIUA can do to lower the tax burden on the member companies so that they're not paying 35 percent but a lower percent?
A. Well, they could probably lower the effective rate by not investing fully in, you know, very safe bonds. That's what their investment philosophy is: safety first. And they're all bonds. They're all taxable. Even the munis are taxable.
Q. Are there investments that the MPIUA could make so that it pays the capital gains tax at lower than 35 percent?
A. You would have to have something that would be invested in stocks generally, and it's the dividends that really are the lower ones, the lower rates.
They've chosen to have a safe investment. They're not in the investment business. So the money they hold is invested in basically a collection of bonds.
Q. Do MPIUA members invest in stocks

generally?
A. Generally insurance companies do, yes. They take that risk.
Q. And they pay a lower tax rate as well, lower than 35 percent?
MR. MEYER: Objection. Pay a lower tax rate on what?
Q. On the capital gains on the investments in stocks.
A. They certainly pay less on dividends. I'm not sure about corporate on capital gains.
Q. Let me draw your attention to Page 1141 in the filing.
A. Okay.
Q. So what is Page 1141 in the filing?
A. What is it?
Q. Yes.
A. It's a current estimate of the cost of debt in an insurance company.
Q. And this estimate of the cost of debt is in the column most to the right; is that correct?
A. Correct.
Q. And the column in the middle that has the heading "Long Term Debt Weight" refers to how much

weight the companies have of debt, as compared to equity; is that right?
A. In their capital structure.
Q. Yes.
A. Right. This is national.
Q. And it's based on a Value Line survey; is that right?
A. Yes. I believe -- I think so. I think we get everything from there.
Q. And here you use four quarters, from the third quarter of 2010 through the second quarter of 2011; is that right?
A. Yes. It's just to take a yearly average.
Q. And these are historic numbers; is that right?
A. Yes.
Q. And is it your opinion that it's appropriate to use historic numbers in this analysis?
A. For this, this particular calculation? Yes.
Q. How did you get from the Four Quarter Summary percentage of 22.73 to the selected percentage of 20.00 percent? Were you just rounding

down or --
A. It's just a judgment of what is an appropriate number to weight the debt. 80/20.
Q. Why is your judgment to lower the debt weight from 22.73 to 20 percent?
A. I can't recall all of the history, but I think that was a number that was in prior automobile rate hearing estimates when the Commissioner was making rates. 80/20 has been around for a while. So the data is just sort of saying things are still in the same rough weighting.
Q. Can you explain what role the data plays in your selection of the 20/80 debt-to-equity ratio?
A. Well, the data that's on Page 1141 I'm viewing as simply whether or not there is a reasonable relationship between the most recent debt weights in all of the companies combined that we look at from Value Line and what the traditional 80/20 was. And my judgment is 20 is still reasonable to weight the cost of debt with the cost of capital, equity capital.
Q. If you had used a debt weight of 22.73 percent in your IRR model, would that change the projected profit provision?

A. If you use a higher cost of debt -- I mean a higher weight?
Q. Yes.
A. Yes, that would lower the cost of capital.
Q. So --
A. The total cost of capital.
Q. The target IRR would be somewhat lower, as well as the underwriting profit provision; is that right?
A. All other things being equal, I guess.
Q. I'm sorry, is that a yes, that those two things would change, the target IRR as well as the underwriting profit provision?
A. Sure. If you lower -- everything else remaining the same, the profit provision would be lower.
Q. The MPIUA is backed by the entire voluntary market in Massachusetts; is that right?
A. That's my understanding.
Q. Would you expect the MPIUA to be able to get better financing terms if it were to take out a loan from a bank than any particular member of the voluntary market in Massachusetts?
A. These aren't loans from banks. These are

bonds that are issued by insurance companies.
Q. Right. Would the MPIUA be able to receive more favorable rates on its bonds than any particular voluntary member?
A. I have no idea.
Q. Does the MPIUA actually issue any bonds?
A. I don't think so, but I don't know for sure. I don't think so.
Q. Does the MPIUA have any actual cost of debt?
A. Not that I can recall.
Q. In the IRR model, the cost of debt is a theoretical construct, right?
A. Well, it's not a theoretical construct. It was a decision of the Insurance Commissioner a few years ago that, in making the estimates from the Value Line companies, that it ought to be a weighted estimate of the cost of equity plus the cost of debt.
Now to say that, well, the FAIR Plan is not exactly the same because they don't issue debt, we could make that kind of an assumption if that were appropriate. I chose to stay within the Commissioner's guidelines and decisions for what

this model looks like, and so we continued the idea of weighted cost of capital.
Q. In the IRR model, do you make an assumption that loss adjustment expenses are 10 percent of the loss?
A. I don't know that we make that explicitly. I mean, we bring over the weights of the components from the actuarial analysis.
Q. Are you familiar with the assumption that LAEs are 10 percent of the loss?
A. I'm sorry, I just don't recall what the actuarial analysis of loss adjustment finally turned out to be. There's an assumption -- there's not an assumption. It's based on data. It's made by the actuary.
Q. Are you familiar with the data on which the estimate of LAEs is based?
A. Not other than what was in the filing that I used. But, no, I'm not responsible for any of that.
Q. Am I correct to understand that your testimony is that the IRR model is structured as though the MPIUA were a self-sufficient insurer?
A. That it was an insurer that had members

equity as the equivalent of policyholder surplus, and that it ran and had the exposures that homeowners policies have. That's the extent of it.
Q. On Page 1057R, you say, "For purposes of modeling the insurance transactions covered by this filing, the IRR cash flows are structured here as though MPIUA were a self-sufficient insurer with members equity functioning as the surplus at risk of use to pay for unexpected adverse claims, expenses and investment income"; is that right?
A. Right.
Q. What do you mean by self-sufficient insurer?
A. Simply that they -- we're assuming that they write insurance policies, given their financial situation, and that the members equity is what's at risk. We do not include contingency assessments or anything else. It's all expected. So we base it on the members equity at risk, and the risk is homeowners, the three different lines. That's about it.
Q. And is your IRR model designed to adequately, fairly and reasonably compensate the MPIUA members for their capital at risk?

A. For the capital at risk in the members equity.
Q. Is there any other capital at risk?
A. Yes. There's the members' own capital at risk for excess losses over the reinsurance program, plus the operations of the FAIR Plan.
Q. Does the filing compensate the member companies for that capital at risk?
A. This filing does not. And I should say, that's because the reinsurance program is almost fully covered.
Q. Do the MPIUA members carry on their books their equity in the MPIUA?
A. I believe so.
Q. Do MPIUA members count that equity as part of their own surplus?
A. I don't know for sure, but it would seem to me that the annual statements include their interest in these various state entities.
Q. Is that interest counted as surplus by the MPIUA members?
A. Say that again?
Q. Is the equity interest that MPIUA members have in the MPIUA considered their own surplus or

part of their own surplus?
A. Well, it goes into calculating their own surplus --
Q. Can they --
A. -- in theory. I mean, I don't know how they all do it.
Q. Can MPIUA members use their equity interest in the MPIUA to back policies that they issue in the voluntary market?
A. I have no idea. I mean, you know, again, in theory they own a piece of the members equity, and the rest of it is sort of the rules of operating. Whether or not they have access to it, I don't know.
Q. In your IRR model, does it make any difference whether the MPIUA holds the members equity in its own accounts or distributes them to the MPIUA members?
A. No. I've made the assumption that we're modeling the actual situation of the FAIR Plan. And so it does make a difference whether the FAIR Plan holds the interest in the members equity, because that's where we start to see what capital is at risk.

And my assumption is that that's the capital at risk, especially now since they do have a decent funding, as opposed to the one back in 2006, let's say. I would have done something different back then.
Q. If the MPIUA distributed, say, $200 million to its member companies, would you use a different amount for the capital at risk in your IRR model?
A. Yes. Probably.
Q. Would it be higher or lower?
A. I don't know.
Q. Do you know how much the MPIUA spent on reinsurance since July 1, 2006?
A. How much that they spent?
Q. Yes.
A. Well, I think that's in Exhibit 9. It's not added up, but it's 2006 to 2010 numbers.
Q. It's in Column 2 of Exhibit 9, right?
A. Right.
Q. And do you know how much the MPIUA recovered from reinsurance since 2006?
A. No, I don't. But I think there was testimony that they haven't recovered, because there hasn't been any attachment fee over the attachment

point.
Q. Now, is it correct that the MPIUA can choose whether to purchase reinsurance or not? There's no law that says the MPIUA must purchase reinsurance; is that right?
A. I'm not familiar with the law. I'm not a lawyer. My assumption is that they choose to have the reinsurance program that they have and that that's an expense. And that's in the actuary's report.
Q. Do you consider, in your IRR model, the possibility that the MPIUA can choose not to have reinsurance or to have a lower amount of reinsurance?
A. Well, I think there's two pieces to the answer. The first one is, if they don't have a full reinsurance program, like they did not in the filing in 2009, then that has to be accounted for, because it switches the catastrophic risk to the member companies, as opposed to the reinsurers, and I accounted for that.
In this case, the reinsurance program was virtually full from the attachment to the upper limit, and so I did not have to adjust the cost of

capital. But if they didn't have the reinsurance program, they would be a much riskier company model, and so the cost of capital would be higher.
Q. In your IRR model, is the full cost of the reinsurance program passed on to the MPIUA policyholders?
A. I mean, I wouldn't put it that way. That's part of -- the other parts of the rate. I assume that that's true, but I don't do it.
Q. For purposes of your IRR model, do you use the entire cost of the reinsurance program as an expense to the MPIUA?
A. I mean, yes, I guess so.
Q. Is it correct that you expect that that entire cost of the reinsurance program is passed on to policyholders through the indicated premiums?
A. I mean, that seems to be the case, but I don't -- it doesn't matter to my calculations.
Q. Do you have an understanding as to how the cost of reinsurance would work in a purely competitive market?
A. My understanding is that the reinsurance market is highly competitive, if that's what you're asking.

Q. I'm not asking about what Mr. Wackerman was testifying about yesterday. But if there's a purely competitive market with regard to insurers, primary insurers and policyholders and the availability of reinsurance, do you have an understanding in that type of purely competitive market who would bear the ultimate cost of reinsurance?
A. I'm not -- I just don't even understand where you're coming from with, quote, a purely competitive market. I work off the real market. What you mean by purely competitive, I'm not sure I understand.
Q. In the voluntary market, do you know whether insurers are able to pass on the entire cost of reinsurance to their policyholders?
A. I certainly don't know in particular, because I don't know all the rates and so on and so forth. I have not reviewed their individual filings. I don't know.
Q. Did you make an assumption in the IRR model that the full cost of reinsurance should be passed on to policyholders?
A. I assumed that it's in the rates, yes.
Q. In your testimony in the filing, you use a

particular definition of fairness; is that right?
A. Generally, yes.
Q. And is your definition of fairness that it's the point at which an insurance company is indifferent, economically indifferent, as to whether to write an insurance policy?
A. Can you point me to where you're talking about.
Q. Yes.
MR. MEYER: Page 1061, Dr. Derrig.
Q. Yes, on Page 1061, in the last paragraph that starts --
A. Hold on. These are still in different piles here. They're getting worse.
MR. LEIGHT: Ask the people in the FAIR Plan to buy you a binder.
A. Okay. Where are we now?
Q. Do you see the paragraph on the bottom that starts with, "In theory"?
A. Yes.
Q. Let me just read the first two sentences of that paragraph. "In theory, the IRR is intended to generate rates at a level such that insurers are exactly indifferent between writing the policy and

not writing the policy (after consideration of all risks involved). That is the meaning of, quote, fair, unquote, as used above."
A. Right.
Q. That's your testimony, right?
A. Yes.
Q. So when you formulated the IRR model, did you make any judgment as to whether the amount of insurance that the MPIUA purchased was an appropriate amount, or did you just take whatever it was that the MPIUA purchased?
A. You're talking about reinsurance?
Q. Yes.
A. Okay. No, I just take the proportion and relate that to the appropriate leverage. That's all I do.
Q. Is it correct that if the MPIUA had purchased a different amount of reinsurance, then your IRR model can generate a profit provision which would be fair, using your definition?
A. Yes, as long as it's accounted for.
Q. So if the MPIUA had purchased a different amount of reinsurance, would that change the target IRR in your model?

A. **If we assume that we're not talking about buying more insurance but buying less reinsurance, then that would change things, yes.**

Q. How would it change the target IRR in your model? I don't mean the specific amount. Just generally, would it go up --

A. **No, no. Generally -- it wouldn't change the format of the IRR at all. It would change and it did change in the 2009 filing by accounting for the fact that a substantial portion of the catastrophic risk was not covered by a reinsurer but rather covered by the members, and that's reflected in the leverage.**

So with the modeling that reinsurers have to have, a much -- have much more capital to premium than an ordinary, regular non-catastrophic company, the risk and the price therefore is reflected in using a lower capital leverage ratio.

And in fact I think I put in the filing the leverage ratio of reinsurers which I think, if I remember, is .88. They have a lot of surplus, because they have to. And then since that leverage is there, that generates a higher underwriting profit.

Q. So with less reinsurance, there would be a higher profit provision in the IRR model?

A. **Correct. And you could think of it conceptually as one piece for the noncovered catastrophic risk, plus another piece where the FAIR Plan is acting as a reinsurer and therefore deserves kind of reinsurance prices for that coverage, and you put the two together.**

Q. Do you have an understanding as to how that would affect the indicated premium for the policyholders?

A. **Yes. The less reinsurance you have, the higher -- well, I shouldn't say that, because you have to compare the reinsurance price for that coverage, which you don't know if you don't have it, with what the extra premium is to compensate the member companies. I did do that kind of comparison. That's perhaps impossible to do.**

Q. If we take the hypothetical that there's zero reinsurance, there would be a higher profit provision in your IRR model; is that right?

A. **I believe there would be a higher profit provision, because the leverage would be much -- the leverage ratio would be much lower. Lower means**

more surplus is attributable to the same risk.

Q. And then there would be no reinsurance premium that would be considered as an expense to the MPIUA; is that correct?

A. **Well, I mean, that's your assumption.**

Q. In this hypothetical, no reinsurance, there would be no reinsurance premium?

A. **No reinsurance premium. If you have no reinsurance, there would be no reinsurance premium.**

Q. Do you know whether the indicated premiums for policyholders would go down if there were no reinsurance purchased by the MPIUA?

A. **Well, in theory -- if my assumptions are okay and perfect, it wouldn't change, because I should be charging, through the profit provision, the equivalent of what the risk should be priced at.**

Now, I mean, that's really way off in the weeds in trying to compare numbers. But in theory, I'm charging for the catastrophic risk that's not covered by reinsurance.

Q. Now, the purchase of reinsurance includes some transaction costs; is that right?

A. **Sure.**

Q. And that includes the commission to the

broker, right?

A. **Sure.**

Q. Do you know of other transaction costs that would be involved in a reinsurance program?

A. **Not all of it, no.**

Q. Do you have an understanding that there are some transaction costs?

A. **Oh, yes.**

Q. So in the scenario in which there's no reinsurance purchased by the MPIUA, so that there would be no need to have those transaction costs from the transfer of risk, would that lead to lower indicated premiums for policyholders?

A. **Well, if I understand your question, that if you just take out the reinsurance premiums, if my underwriting profit were perfect, which it isn't, then the net result should be the same. On the other hand -- because if the charge for the reinsurance premium is not there, then it has to be absorbed somewhere. And so if the model were perfect, the underwriting profit were perfect, it would roughly be the same.**

On the other hand, if there were no reinsurance for the FAIR Plan, I would suspect that

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the underlying companies would be buying reinsurance against the FAIR Plan's loss. And just considering the fact that there is one reinsurance program here, as opposed to -- I don't know how many companies there are -- but hundreds of companies buying individual little pieces of reinsurance, that that probably costs more than, you know, having it consolidated to precisely the risk, which is the risk of the FAIR Plan policyholders.

Q. Let me get to the scenario of the voluntary companies buying reinsurance in a moment, but what I'm trying to get at is --

A. Well, buying reinsurance for the FAIR Plan losses.

Q. Yes.

A. Okay? So that means their policyholders would pay for it, as opposed to the FAIR Plan.

Q. Let me get to that in a moment. What I'm trying to get at first is, where does the savings in transactions costs, such as the commission to Guy Carpenter, the reinsurance broker, which is built into the reinsurance premium, what happens to that transaction cost in this model if we assume that there's no reinsurance? What happens to that

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savings in transaction costs?

A. I really don't quite understand. The only thing I can say is what I just said. It would be distributed back to the voluntary companies. And either they bear the risk themselves, or they buy, in their reinsurance programs, all these little pieces, which add up to the ones of the FAIR Plan. And I suspect it would cost more, but maybe not. I don't know. I don't know what they do. But they would have the same transaction costs.

Q. The voluntary market?

A. I would think so. It sounded like 10 percent was the sort of standard.

Q. Does the voluntary market have to purchase reinsurance for its exposure to the MPIUA?

A. I don't think so.

Q. They have the option of holding surplus, right?

A. They have the option of bearing the risk.

Q. Well, they could bear the risk by holding surplus or by buying reinsurance or some combination, right?

A. No. It's a difference. I mean, they have surplus. Now you're asking whether or not they can

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just add on some more risk for the same surplus. If they do, then presumably they have to charge more, right?

Q. Would the amount they would have to charge more equal to the premiums they would have to pay for additional reinsurance?

A. Right, which include transaction costs.

Q. So they would have to -- even if they did not buy reinsurance, the voluntary market members would have to charge for the transaction cost of buying reinsurance; is that what you're saying?

A. No, that's not what I'm saying. If they don't buy it, they don't pay a transaction cost. They bear the risk themselves.

Q. Is there any savings to the member companies if they don't buy reinsurance but bear the risk themselves?

A. My guess is that there isn't any savings in the large. There might be cash savings, you know, up to having experienced a catastrophe, in which case they've got to pay it all out themselves. That's a different question.

Q. Do you have an opinion as to whether voluntary market members would save on the total

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cost if they decided to bear the risk from MPIUA assessments themselves, rather than purchase reinsurance?

A. You didn't mean investments, did you? You mean writing insurance?

MR. KLIBANER: Can I have my question read back, please.

(Question read)

A. Oh, assessments. No, I don't know.

MR. KLIBANER: Thank you, Dr. Derrig. I don't have any further questions.

PRESIDING OFFICER FARRINGTON: It's noon. Shall we just -- how much --

MR. LEIGHT: You know, I don't have all that much. Maybe we could just take a few-minutes break and just finish it up.

PRESIDING OFFICER FARRINGTON: Why don't we take a ten-minute break and come back.

MR. MEYER: Sounds good.

(Recess)

PRESIDING OFFICER FARRINGTON: Shall we go back on the record.

BY MR. LEIGHT:

Q. Dr. Derrig, could you tell us whether, in your view, a contingency provision is the same as a risk load?

A. Yes, I can. It's not the same.

Q. Could you tell us what the difference is, in your view.

A. Well, in my view, the risk load, as such, is probably not a great term, but it's used by actuaries all the time. And a contingency, as we read into the record earlier, is an extra factor, besides modeling what the appropriate underwriting profit provision would be, due to the inadequacies of the rest of the actuarial analysis.

As I think I said, that's kind of an old version of ratemaking that goes back before financial models for calculating underwriting profit provisions really came in. And as far as I'm concerned, it's just -- it's not used. It's not used here. It's not used much elsewhere. And it was -- it's still a part of the lore, and that's why it's in the ASOP.

Q. In the IRR, the profit provision is intended to provide the company with adequate remuneration for the risk load?

A. For the risk they bear. Right.

Q. Now, on 1181 -- this is where you were looking at the definitions before with Ms. Moran -- there's also a definition of underwriting profit?

A. Yes.

Q. Is that definition consistent with your understanding?

A. (Reviewing document) Well, 2.14 and 2.15 on Page 1181 are just two ways of saying the same thing. We generally mean the same for both of those.

Q. And are they consistent with your understanding generally?

A. Yes.

Q. Do you know whether the Commissioner has ever approved a FAIR Plan filing with a profit provision greater than zero percent?

A. Well, I have limited experience in this area, but in the last two filings, including this one -- I don't think the Commissioner approved the last one. There was a negotiated settlement. So if your question is approved, then I think at least right now the answer is no.

Q. Do you know what the indicated rate increase would be if the profit provision in the

current filing were zero percent?

A. Not offhand.

Q. You didn't calculate that?

A. No.

Q. Apart from the treatment of taxes, which you went over a bit earlier this morning, is there any difference between the way you implemented the IRR model in the filing and the way you would have implemented the model had the filing been for a voluntary market company?

A. There would be no difference if it were a voluntary company with exactly the same characteristics.

Q. Right. All else equal.

A. Yes, everything else equal.

Q. And the tax -- can you just explain to us how the tax treatment in the current filing differs from the tax treatment that would have been applied if we had been dealing with a voluntary market carrier.

A. There's actually no difference. It's just that -- let's say, if we harken back to the automobile insurance filings, generally insurance companies own different securities, and they --

actually, the asset yield exhibit shows the different categories.

And for the most part, companies have bonds, stocks that are accounted for. For corporate tax purposes, there are preferences, but they're virtually all on the stock side. And because the FAIR Plan only invests in bonds, fully taxable bonds, as I explained before, there is a full 35 percent, because underwriting income is always 35, whether it's positive or negative. And all of this investment income that's expected, because they invest only in taxable bonds, is interest, and interest is taxed at 35. And because finally, as opposed to an insurance company that pays things as it goes, our cash flow model has to combine everything at the end, because that's what goes to the insurance companies underlying the voluntary companies, and then pull back the taxes that that piece would -- the tax liability that that piece is expected in the voluntary company, and it's 35. So that's the changeover.

Q. Now, in determining the cost of capital, you use a sample of the Value Line companies, correct?

A. **Correct.**
Q. Would it be correct to say that the cost of capital is an average of the sample values?
A. **I'm sorry?**
Q. Is it an average of the values for the sample companies?
A. **Yes.**
Q. The MPIUA is not in the sample, correct?
A. **No.**
Q. Do you know whether there are any companies in the sample that write homeowners insurance only?
A. **I don't know, but I suspect there probably is not.**
Q. Most of the companies are multi-line companies, correct?
A. **They're multi-line, correct.**
Q. And similarly, none of the companies that you're aware of writes insurance solely in Massachusetts?
A. **That's probably correct, yes.**
Q. So there would be no companies that only write homeowners insurance in Massachusetts in the Value Line sample?
A. **Well, assuming there aren't any, yes, there**

wouldn't be any.
Q. Do you know whether there are any?
A. **No, I don't. I suspect there are not, because these are national companies.**
Q. Now, on Pages 1068 and 1069, if we could turn to those pages, it deals with the underwriting surplus flow.
A. **1068, 1069?**
Q. Yes.
A. **Okay.**
Q. On these pages you discuss the net/gross issue with respect to subrogation recoveries, correct?
A. **Yes.**
Q. Could you explain to us, in general terms, what the subrogation recoveries referred to here are.
A. **Well, I'm not extremely familiar with it, but I do know that there are recoveries on claims due to the two pieces, salvage and subrogation, and the FAIR Plan keeps track of it. And --**
Q. You're not familiar with the actual mechanism --
A. **Exactly how they do it? No.**

Q. Or where they come from, what other insurance --
A. **Well, they come from claims where they can recover some of the damaged property that they've already paid a claim for, let's say a total, and they end up with, you know, the partially burned whatever, and they get some salvage. I mean, this is common.**
And subrogation means that there's somebody else who is actually liable somehow, and so they get some money back. And to get the total payment, including salvage and subrogation, you have to net them out.
Q. The model also has a column for reinsurance recoveries, correct?
A. **Can you point me to a page.**
Q. Well, for example, if you turn to Page 1085 -- there are similar pages for each of the major coverages, but if you look at Page 1085, Column 6a --
A. **Okay. 1085. Right.**
Q. Do you see that column?
A. **Yes, I do.**
Q. Where do the numbers in this column come

from? Did you calculate them?
A. **I believe so.**
Q. And how did you calculate them?
A. **I believe just generally that I calculated it based on what the expected losses were that would be covered by reinsurance, and that in the reinsurance program, the gross loss would be what in fact was covered by reinsurance. And the little offset is my representation of the delay between the primary company paying the claims and the reinsurer/broker reimbursing them for the claim. And it's assumed in the model to be half of a quarter, just to have kind of the minimum delay.**
Q. In terms of the aggregate reinsurance recovery, is that a number that was supplied to you by Mr. Ericksen?
A. **Yes, one way or the other. I think -- it's in the expected.**
Q. Right. But did you calculate that expected value, or was that calculated by Mr. Ericksen?
A. **No, I didn't calculate that myself, I don't think.**
Q. So you basically accepted the value that Mr. Ericksen had calculated for the reinsurance

recovery?
A. I believe that's correct. The only thing I contributed was that there was an assumed delay of half a quarter between the payment and the recovery.
Q. In the IRR model, is it correct that you used gross losses rather than net losses after reinsurance and subrogation recoveries as the basis for determining surplus requirements at time zero? And if you want to look at a particular column, that's Column 5 on Page 1090. That's the surplus account.
A. Okay. You're pointing to Column 5?
Q. Column 5, "Surplus Account" at time zero.
A. I'm sorry. Was there a question?
MR. LEIGHT: Could you read it back.
(Question read)
A. I think for this purpose, yes.
Q. And similarly, if we look at the "Required Policyholder Account Balance" column that's the same page, 1090, Column 1, and if we're looking at the required policyholder account balance at Quarter 1, also gross losses are used to determine that value, correct?
A. No. That's the premium.

Q. The required policyholder account balance is the premium?
A. Yes. The structure of this IRR model, which Kim Barber and I introduced over on the auto side, is we keep separate the flow that comes from the premium that's paid by policyholders and the surplus that's contributed by the insurer.
And according to the rules that are set up, each of those balances are adjusted to the rules for every quarter. And as you can see, Quarter 1 and Column 1, the policyholder account balance is basically the premium paid.
And then as the claims are paid, the policyholder's side of the assets decreases to zero. And then the excess, so to speak, or deficiency is because of the investment income that comes from and attributed to the policyholder. And then over to -- all the way over to 4 is the final policyholder account balance.
So we keep them separate, and then we attribute the investment income on the premium to the policyholder, because it's being used partly to pay for the claims. And the surplus account that's needed to support the outstanding liabilities starts at whatever the ratio is and then decreases as the outstanding liabilities decrease.

Q. If you turn to Page 1082, which is the page with the formulas on, and look at the formula for Column 1, Page 7 --
A. Okay.
Q. -- do you see that gross loss and expense are used in calculating Column 1?
A. Where -- is that roughly in the middle of the page?
Q. Yes. Page 7, Column 1. Formula.
A. Right.
Q. Is that consistent with your understanding?
A. Yes.
Q. And that refers to the Column 1 on Page 1090 that we were just looking at, correct?
A. Yes. Generally speaking.
Q. That's the formula for that column, correct?
A. Yes.
Q. Now, do you recall that the methodology of determining surplus based on gross losses rather than net losses was rejected by the Commissioner in the auto decisions?

A. No.
Q. You don't recall that?
A. No.
Q. Is it correct that the way you model the insurance transactions, policyholders fund surplus at time zero as if the reinsurance recovery were zero?
A. I'm not sure that's the right way to describe it, because we separate the policyholder's account that comes from the premium paid from the surplus that underlies the outstanding liabilities.
Q. If you turn back to Page 1085, which is Page 2 of your model, if you were to look at that page and focus on Column 6a and convert every value in that column to zero, can you tell us how that would change the required surplus account at time zero?
A. I really don't understand your question. You mean, if there were no reinsurance, how would this change?
Q. If --
A. Because there are no recoveries?
Q. If the numbers in Column 6a were zero, would that change the value in the surplus account

on Page 1090, Column 5, at time zero?
A. Well, if Column 6a being zero means that there is no reinsurance --
Q. No. It means the numbers in Column 6 are zero. There is reinsurance, but zero -- we're assuming zero reinsurance recovery. So the policyholders are paying the reinsurance expense but getting nothing for it. And I'm asking you whether, in that scenario, the surplus required by the policyholders would be different in Column 5 on Page 1090.
A. Well, I'm not sure the premise of your question is correct. That is, the policyholders are getting the risk of catastrophic losses covered by a reinsurer, and they're paying for it, and they get that as a benefit. They're renting capital, is the way it's viewed financially.
That capital that the reinsurers have that's available to pay for all of the coverage is what it is. It's not that they get no value if there is not a catastrophe. They've lived through a whole year of coverage.
And the coverage is renting the capital. It's like options. It's an option to, in the event

of a loss, go to another party and tell them to pay. So it's an option.
Q. Is it correct that your model is implemented on a spreadsheet?
A. Yes.
Q. If we took the spreadsheet and placed zeroes in all the columns and all the entries in Column 6a on Page 1085 -- do you follow that question, that portion of the premise?
A. Yes. You just put zeroes here.
Q. How would that change the value in Column 5 on Page 1090 at time zero?
A. If I understand your question, what it would do is, it would transfer Column 5a into Column 5. There would be no reinsured losses. These are all on an expected basis. They're not on an actual --
Q. I'm asking you a simple question. Would the number change? Would the number on Page --
A. Well, if you change the numbers, the numbers change, sure.
Q. How would it change?
A. The best I can do for that question is that it would combine -- with that assumption, there is

no recovery means there is no reinsurance to me, which would mean Column 5 would now consist of the sum of Column 5 and 5a.
Q. Can you look back at Page 1082 at the formulas and go through the formulas on Page 7 with me and tell me which of those values would change if we changed the numbers in the reinsurance recovery column.
A. Where on 1082?
Q. Look at Column 5, the formula for Page 7, Column 5.
A. Yes.
Q. Can you tell by looking at that formula whether changing the reinsurance recovery would have any impact on the required surplus?
A. Not from just looking at that.
Q. You can't tell?
A. No.
Q. Now, if you turn back to 1069, you see the equation in the middle of that page?
A. Yes.
Q. Is "Surplus i" a reference to what we were just looking at in Column 5 on Page 1090, the surplus account?

A. Yes, I think so.
Q. The next term, "Gross Outstanding Losses i," is that a reference to gross loss and expense outstanding? And you can look at Page 1087, Column 3, if you want a reference to that.
A. (Reviewing document).
THE WITNESS: Just read the question back.
(Question read)
A. I think so.
Q. And the next term in the numerator, "Net Losses," is it correct that that is a term that refers to non-reinsured gross losses, minus salvage and subrogation recovery?
A. I think that's what we mean.
Q. And that number would not include expenses or anything having to do with reinsurance, correct?
A. I'm not sure whether it includes the net expected losses with the reinsurance.
Q. What about expenses? Do you know whether it includes that?
A. I'm not sure whether that's in there in this simplified version.
Q. And what about the denominator in that particular term, the "Gross Losses"? Do you know

what that is?
A. **Well, I mean, just literally it's supposed to be the losses, but in the kind of cash flow, you start with the premium, which includes expenses.**
Q. So what column would that refer to, do you know?
A. **What, the "Net Losses"?**
Q. The "Gross Losses."
A. **"Gross Losses"?**
Q. Is the "Gross Losses" in the denominator in that second term the same as the "Gross Outstanding Losses" and expenses in the first term there?
A. **It's the same, only the first term is as you flow through the policy payments. So the "Surplus i" is equal to the "Gross Outstanding Losses," in other words the reserves for each of these quarters; and then it's modified by two of these fixed numbers, which is total "Net Losses" over "Gross," and "Surplus" over "Net Losses."**
Q. Does the gross loss in the denominator of the second term include expenses, or is that just losses?
A. **I just don't recall.**
Q. And the third term, "Surplus" over "Net

Losses," is that just the inverse of the leverage ratio?
A. **Generally, yes.**
Q. Is it correct that the reserves value in the leverage ratio does include outstanding expenses?
A. **Insofar as it's portions of premium, yes.**
Q. Right. Now, if you turn to Page 1071, look at the "Expense Flows" section.
A. **Okay.**
Q. It indicates here that the expense flow is based on a historical survey for Massachusetts auto ratemaking?
A. **Yes.**
Q. Do you remember when that was done?
A. **Well, the real answer is no.**
Q. Do you know whether there has been a similar analysis of the expense flow for homeowners?
A. **No.**
Q. Now, the leverage ratio in the model is a three-year average based solely on MPIUA data, correct?
A. **Can you point me to what you're referring to.**

Q. 1158 is an example of the calculation.
A. **Correct.**
Q. Do you recall that in the auto decision, the leverage ratio used by the Commissioner was a five-year average of values, and it was an all-lines, countrywide value?
A. **I don't recall that.**
Q. Did you consider using the Commissioner's leverage ratio in this model for the MPIUA?
A. **No.**
Q. The asset return, when you calculate that, uses an asset distribution of the MPIUA alone, correct?
A. **Correct.**
Q. Do you recall that in the auto case, the approved method for asset return was a countrywide, all-lines distribution?
A. **No, I don't recall that.**
Q. Is it correct that the MPIUA's -- the calculation of the corporate debt uses an embedded value?
A. **Yes.**
Q. In calculating the bond yields on Page 1079, you used the current time to maturity of the

bonds rather than the actual duration of the bonds to calculate the interest rates, correct?
THE WITNESS: Can you read that back.
(Question read)
A. **They are the duration of the bonds as held.**
Q. Let's just take an example so it's clear what we're talking about. Let's say we have a 20-year bond that was purchased 15 years ago -- it has 5 years left -- and we're comparing that to a bond purchased this year, a 5-year bond. You would treat those both as 5-year bonds for purposes of calculating the interest return, correct?
A. **Did you say there were 5 years left in the original one?**
Q. Yes.
A. **Yes, those are the same -- they would have the same interest rate expectation.**
Q. And do you recall that this method of calculating bond yields was rejected by the Commissioner in the 2004, 2005 and 2007 auto decisions?
A. **Well, it's unfortunate that it was, because this is --**
Q. I think that's a yes-or-no question.

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A. No, it's not a yes-or-no question.
MR. MEYER: Let the witness finish his answer.
A. It's incorrect. And one of the reasons it's incorrect is that the value of the assets themselves are the market values of all those bonds. They're not the original issues. They're the current market values.
And the income on current market values of everything that the FAIR Plan holds would equilibrate between a current 5-year and a 20-year with 5 years left, because the market value would have changed.
So the base is appropriately matched with the remaining maturity, not the original maturity.
MR. LEIGHT: Could you read back my question.
(Question read)
Q. Can you answer that question?
A. Yes. I did. I said yes, and I said incorrectly.
Q. Now, is it your view that the FAIR Plan, all else equal, should earn the same profit as a voluntary market company, a higher profit or a lower

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profit?
A. The correct pricing of the policies that the FAIR Plan issues should be based on what the actual total costs are, if they are to be separate and sustainable on their own, without subsidies.
Q. Let's take the two situations. You have a voluntary market company here, and you have a FAIR Plan here, and everything about them is otherwise exactly the same. Should they earn the same profit?
A. For the same policy, yes.
Q. Now, are you familiar with the NAIC?
A. Yes.
Q. Have you ever reviewed NAIC profitability reports?
A. The reports?
Q. Yes.
A. Yes. At times.
Q. I'd like to show you the homeowners profitability report for 2010 and mark it for identification.
PRESIDING OFFICER FARRINGTON: Mr. Leight, how long do you anticipate? It's one o'clock, and I think people may be getting hungry.
MR. LEIGHT: We're getting to the end.

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Maybe another five or ten minutes.
PRESIDING OFFICER FARRINGTON: Do you want this marked for identification?
MR. LEIGHT: Yes, I would like this marked for identification.
PRESIDING OFFICER FARRINGTON: It would be Exhibit 10.
(Document marked as Exhibit 10 for identification)
BY MR. LEIGHT:
Q. Are you generally familiar with this kind of format for the Homeowners Multiple Peril Report from the NAIC?
A. I'm just generally familiar with their exhibits on various things.
Q. Are you aware that the NAIC calculates underwriting profit on an annual basis by state?
A. I think they do.
Q. And are you aware that that calculation is based on direct premiums earned?
A. Yes, but I don't know what the other side of it is.
Q. The other side of it?
A. Yes.

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Q. What do you mean, the other side?
A. Well, the underwriting profit is premiums minus, you know, losses, expenses.
Q. Could you tell us what direct premium is.
A. Direct premium is the actual premium on policies that they sell.
Q. Do you see that the -- or is it your understanding that the NAIC takes the direct premium, subtracts off losses and expenses, and then calculates dividends to policyholders, taxes and so forth --
A. I'm sorry. I can't hear the last part.
Q. I'll start over again. Is it your understanding that the NAIC, when it calculates underwriting profit, subtracts from direct premium losses, expenses, taxes and dividends to produce the underwriting profit?
A. That's what it looks like.
Q. The calculation of underwriting profit does not take into account payments for reinsurance, does it?
A. I don't know specifically.
Q. Have you reviewed the FAIR Plan's profitability since 2006?

A. Not other than in the exhibits that the SRB gave out.
Q. Have you compared the FAIR Plan's underwriting profit in any year since 2006 to the underwriting profit at the voluntary market as a whole during any of those years?
A. No.
Q. Do you know whether the FAIR Plan's profit during those years was higher, lower or the same as the voluntary market in any of those years?
A. The voluntary market where? In here, in the exhibit?
Q. No. Do you know whether the FAIR Plan's profitability, in any year since 2006, was higher than, lower than or the same as the voluntary markets in any particular year?
A. Which voluntary -- Massachusetts or everything?
Q. Massachusetts.
A. So the line in here?
Q. This is 2010.
A. The line in Exhibit 10?
Q. 2010, for example, shows Massachusetts voluntary market profit, underwriting profit, in

Line 8. Do you see that?
A. Yes.
Q. And did you compare that underwriting profit to the FAIR Plan's profit in 2010 or any other year to determine whether the FAIR Plan was earning more, less or the same as the voluntary market in that year?
A. No.
Q. And do you know whether the FAIR Plan is more profitable than the voluntary market?
A. No.
Q. Does it matter to you?
A. No.
Q. Now, in the FAIR Plan's rates for the years between 2006 and 2010, there was no provision for underwriting profit, correct?
MR. MEYER: Objection.
A. There was none before --
MR. MEYER: Objection. The question states a fact that is known to the questioner to be incorrect, and it is unethical to ask a question that recites a fact that is incorrect; rates for 2010 didn't include an underwriting profit.
Q. Rates for 2010 were stipulated, so let's

remove that from the question. Are you aware of any underwriting profit in any filing that was not stipulated between 2006 and 2010?
A. I don't know what came before 2010. My understanding is that there was a zero profit included in the rates, underwriting profit.
Q. Do you have any understanding of what the impact on the FAIR Plan's profitability would be during the years between 2006 and 2010, excluding the stipulated year, had the profit provision in rates been 5.8 percent rather than 0 percent in any of those years?
A. Well, presumably the direct premiums would be increased.
Q. That would have increased the FAIR Plan profitability, correct?
A. Correct.
Q. Now, on Page 1158, which we looked at earlier, which is the leverage page, the FAIR Plan is shown as increasing its surplus from $56 million in 2006 to $247 million in 2010. Do you see that?
A. No, I don't -- hold on. 1158.
MR. MEYER: I think the page he asked about was 1058.

MR. LEIGHT: It's 1158.
A. 1058 or 1158?
Q. 1158.
A. I have it.
Q. Just referring to the "Surplus" column in that page, this shows an increase in the FAIR Plan's surplus from 2006 through 2010 of about 336 percent. You're welcome to do that calculation, if you want. You can see that it's a significant increase, correct?
A. Yes.
Q. And this increase in surplus does not remove the impact of reinsurance purchases during that period, correct?
A. I'm not sure I know what you mean by remove the impact of reinsurance.
Q. The surplus increases are after -- the surplus in each year is calculated by removing the dollars that are spent on reinsurance, correct?
A. I don't know that.
Q. You don't know.
A. I've put the numbers in here that are in the financial statements under "Members Equity."
Q. And do you know whether, in the financial

statements, the surplus is calculated as a net value after subtracting the amount spent on reinsurance?
A. **I would assume so.**
Q. Is the surplus a pre-tax number or an after-tax number?
A. **It's what the members equity is. I don't believe the FAIR Plan pays taxes itself. The members pay. So I don't -- I can't relate your question to this.**
Q. Okay. Certainly the members -- if the members were to pay taxes, that would not be included in the FAIR Plan financial statements; is that fair?
A. **That's correct.**
Q. Do you know whether any voluntary market company has earned a return of surplus during this period that's greater than 100 percent, any voluntary market company writing homeowners insurance in Massachusetts?
A. **I don't know.**
MR. LEIGHT: That's all I have. Thank you.
PRESIDING OFFICER FARRINGTON: I just have a couple of questions.

EXAMINATION
BY PRESIDING OFFICER FARRINGTON:
Q. Getting back to the leverage ratio, I notice on Page 1157, in your 2009 filing you used a single year, the ratio for a single year, 2008.
A. **Yes.**
Q. And this year you've used a three-year average.
A. **Right.**
Q. What's --
A. **Why?**
Q. What is the rationale of your different methodology for this filing?
A. **Well, the slightly different methodology was simply that the actual reserves-to-surplus ratio on Page 1158 was coming down by quite a bit because of the retention in the FAIR Plan of really the increase in the members equity.**
And so I wanted to moderate the sort of precipitous reserves-to-surplus from 2008, 152, down to 95. I didn't want to use that last one. I thought that was -- that was a bit too much.
And so I, on my own, took a three-year average, and 120 seemed to be not unreasonable, with

the projected surplus coming from the last financial statement to where we are now of $280 million. That's just a judgment.
Q. Several times you've addressed the concept of members equity. In the introduction, is this what you're also referring to as their invested capital? Are you using that equation? This is on Page 1061 in the first paragraph.
A. **It's just that the financial models, such as this one, we have to have the situation where there is some capital available that's invested in underwriting the insurance. And that invested capital, because the insurance is a risky operation, deserves a return to the capital commensurate with the risk. That's the basic principle.**
For the actual FAIR Plan, it gets a little more complicated, because the FAIR Plan doesn't really own anything as a risk. The members, voluntary market companies, are treated like the investors in a company.
Q. So when you say "invested capital," you're really just -- it's a different phraseology --
A. **It's just a little different, to try to represent the fact that the individual member**

companies are the investors who put their capital, members equity, at risk to write the insurance. And therefore they fit into the general financial modeling of, the owners of the capital that's at risk underneath the insurance policy are the ones who deserve the return -- I'm sorry, the expected return.
PRESIDING OFFICER FARRINGTON: That's all I have. Thank you.
BY PRESIDING OFFICER SUMNER:
Q. I'm wondering if you can help me. Some of the references in your testimony, I couldn't quite -- I couldn't with certainty or confidence identify what exhibit you were referring to.
So on your page -- well, on Page 1080 of the filing, the third line up from the bottom, you refer to Section VIII, Exhibit 3, but my copy of Section VIII does not have an Exhibit 3. So maybe you could help me out with that.
A. **Okay. Section VIII is the asset returns.**
Q. Yes.
A. **Which is the very last thing in the filing. It's after leverage.**
Q. Well, you have appendices also. The last

page I have in that section is 1167, which is Exhibit 2, Page 2, and I don't have an Exhibit 3.
A. You're correct. It's not there.
Q. Is the reference incorrect, or is the exhibit missing --
A. No. Let me just read what's supposedly here. (Reviewing document) No, it's just -- it was not included. That's my fault. I can supply that.
Q. The next one I had a problem with was your discussion of Section VI, "Derivation of Cost of Capital," which begins on Page 1073.
A. Okay.
Q. Then going forward to Page 1077, you're still discussing Section VI. The last line under C, "Cost of Equity Capital Calculation," you make a reference to Exhibit 4, Page 2, but Exhibit 4 I have has only one page. That's on Page 1150.
A. On 1077 you're looking at the middle of the page, "historical equity risk premiums"?
Q. The line right above "D. Adjustments to Equity Cost of Capital." See the reference there to Exhibit 4, Page 2?
A. Yes.
Q. There is an Exhibit 4 in Section VI, but it

is only one page long. So I'm confused about that.
A. Okay. Let me take a look at --
Q. As I said, that's on Page 1150, if that's the right exhibit --
A. Oh, you mean where it is. That's helpful. Well, historic risk premiums, equity risk premiums are indeed on 1150. That's a 1926 - 2010 Morningstar.
Again, I must have overlooked that and changed it when there's only one page. I mean, that's all there is.
Q. So it's the correct exhibit --
A. That's it.
Q. -- but it's just on a page.
A. There is no other page. It shows all the risk premiums. And perhaps in an earlier version there was an explanation of what it means, but the numbers are all correct. These are the historic risk premiums.
Q. If you go to Page 1072, this is in your discussion of Section V, "Calculation of Risk-Free Rate." At the bottom of the page, under "Twelve Month Average," you refer to "See Exhibit 5 this section" under Section 1. I didn't know -- if you

were referring to Section V, it doesn't have an Exhibit 5, and if this was Exhibit 5 of --
A. Oh. Under No. 1?
Q. You see where it says, "(1) It lessens the fluctuations, while reflecting..."
A. Right.
Q. Then it says in parentheses, "See Exhibit 5 this section." Is that Section Roman numeral V?
A. It should be in the asset section, the asset yields.
Q. Are you saying it should be in Roman numeral VIII?
A. Yes. I think that's -- unfortunately, that's left over from some profit filings from years ago, when this was an issue. It's probably 10, 15, 20 years ago. There are exhibits of all of the Wall Street Journal strips, which I did not include.
Q. Okay. On Page 1071, you're discussing, under Section IV, "Policyholder Cash Flows," Subsection A, "Premium Flows." You make a citation to "Section IV, Exhibit 4, Page 1," but I don't have an Exhibit 4 in the Section IV that I have.
A. What it's referring to is the flow on Page 1085 for one of the lines, where you can see the

premium is all in Quarter 1. So it's in the actual calculations.
Q. So replace that reference with Page 1085?
A. Yes. It's 1085 for homeowners, and it's the same for the other three coverages. It just refers to the assumption we made that the premium is paid at the policy inception, as opposed to having some payment schedules with interest charges, et cetera, because there's very little.
Q. On that same page, under "B. Expense Flows," I just would like some clarity on this. The second paragraph under "B. Expense Flows," you write that "The commission expense flows reflect commissions as a fully prepaid expense at policy inception. This pattern reflects the actual payment practices of companies writing Massachusetts private passenger automobile insurance."
Do your IRR calculations for this filing reflect the actual payment practices of companies writing Massachusetts homeowners insurance?
A. Well, it's the assumption that is over in the private passenger automobile insurance, that for the purposes of calculation, we assume that the commission is paid at the beginning of the policy,

independent of how actual cash flows back and forth to the agent and so forth. And that was -- that's been an assumption for years.
Q. Right.
A. And I just used the same one.
Q. The filing that we're looking at, though, is for homeowners insurance. So my question for you is, do the commission expense flows that you have used reflect the actual payment practices of companies writing Massachusetts homeowners insurance?
A. No. It's the same assumption that was used in private passenger auto.
Q. Is there any basis for your using that assumption for homeowners insurance?
A. Not other than -- my recollection is this is a long-time assumption used by the Commissioner, first in auto and then continued in competitive rating. It's an assumption.
Q. Okay. I think Mr. Leight had asked you this, but just since we're on the page already, in the next paragraph you deal with underwriting expenses, and you say that the underwriting expenses flow "is based on a historical survey previously

adopted for Massachusetts automobile ratemaking." Do you know of any historical surveys involving Massachusetts homeowners ratemaking?
A. No, I don't.
Q. The page before that, Page 1070 -- this is in your discussion of Section III, "Expense/Loss Ratios" -- at the end of the first paragraph, you refer to "Weights for the various flow components are based on the indicated levels in this filing as shown in Exhibit 1, Page 2," but I'm not -- I don't see a Page 2 on the Exhibit 1 of Section III in the filing I have.
And I guess that would be Page 1112R -- wait a minute. I'm sorry. Exhibit 1 is 1110R, Exhibit 1, under III. At least as far as my filing is concerned, that's only one page.
A. That's correct.
Q. So should the reference just be to Exhibit 1 and strike the Page 2?
A. Yes, it should. I think perhaps the previous version for the previous filing had two pages, but this is much simpler.
Q. Okay. I just wanted to make sure I wasn't missing a page.

It seems to me that your IRR models, one of the assumptions you're making is that you're going to treat the MPIUA just as you would a regular insurer.
A. Correct.
Q. Is that a fair statement?
A. Yes.
Q. Are there ways in which the MPIUA is not like a regular insurer, however?
A. There are ways, but they don't affect the risk that they face by underwriting policies and paying the losses and so forth with the capital that they have. So that's the only aspect that we need to be able to model returns this way.
Q. One of the differences, though, is it not, that what you're calling shareholder equity is taxed to the shareholders even if it's not distributed, which would not be true --
A. Yes.
Q. -- of a mutual company, let's say. Until there was a dividend, individual owners equities, they wouldn't be having any tax effect, would they?
A. No, I think they have -- mutual companies are taxed.

Q. I'm saying but the individual equity investors don't have an income tax on money that the mutual keeps, do they? I mean, we don't have to talk about a mutual. Even a stock company, if there is no dividend paid to the stockholders, they wouldn't have any tax result, would they?
A. Yes, but that's the difference between personal and corporate tax law, I would think, which I am a not an expert in.
Q. Well, couldn't there be different concerns by the member shareholders and regular shareholders in a private company?
A. Yes, there could, but the way that the U.S. system works, I don't think they have a -- they can't exercise a claim against the company for their equity and demand payment as an individual shareholder.
Q. Well, for instance, the shareholders of an insurance company, a profit-making insurance company that isn't a residual market company, there's going to be some pressure on management to pay dividends, won't there?
A. Sure. Generally.
Q. But with respect to MPIUA member

shareholders, if the money is paid out or if it's kept in the MPIUA, the tax result is the same, isn't it, if I understood your testimony?

A. Yes. Whether it's distributed to them or it's retained by MPIUA, the tax liability in that year is the same.

Q. And does the MPIUA differ from the regular insurance company in that they're not looking to encourage people to buy insurance from them?

A. Because they're a residual market, I assume.

Q. I think you could say by definition they're not. They're not incurring some of the expenses another company would have incurred for advertising or trying to get the best competitive rate --

A. Right.

Q. -- so that they could compete with other companies.

A. That's right, but that's presumably reflected in their expenses.

Q. The IRR model was used when fixing and establishing automobile rates for the voluntary market, wasn't it?

A. Well, in the market where the state sets the rates for whoever wants to use them.

Q. Right, in the past. Do you think there's any difference between using the IRR model in fixing and establishing rates for insurance offered on a voluntary basis by automobile insurers, as compared to using the same model for residual market entities such as the MPIUA?

A. The relevant considerations are the same; that is, there are investors -- in this case, it's the voluntary company -- that put their capital at risk in an insurance environment, and they deserve an expected return, commensurate with the risk to their capital. The analogy, I think, is very close.

Q. I'd like to turn back to Page 1058. You were asked about this before, but I just would like to go over it with you again. This is the paragraph that begins "Additionally."

A. Okay.

Q. This is the paragraph at the bottom of the section above "Underwriting Profit Provisions in MPIUA Rates."

A. Yes.

Q. "Additionally, the members of MPIUA bear the risk of losses from hurricanes that exceed the reinsurance attachment of $200 million and are not covered by the reinsurance treaty. Therefore, members act as reinsurers for these expected losses and allocate an appropriate level of capital to underwrite these expected losses." And then you refer to Section VII, a leverage section.

It's the allocation verb that I would like to ask you about. Are you saying that they actually identify an amount of capital somewhere, or is that just a colorful way of saying it's an identifiable amount of money somewhere?

A. I think neither.

Q. Okay.

A. What it's referring to is that the FAIR Plan writes the primary insurance, and that covers expected catastrophes. The reinsurance program covers the catastrophe losses above the attachment point, below the limit, and does not cover any piece of a layer that is not reinsured.

And in the case of the previous filing, there were large amounts of the layers that were not covered by the reinsurance treaty. In this one, it's very, very small. There's a little piece in the third layer, I think, that's not covered because there's a 5 percent co-pay with the reinsured.

And in the general set-up, I make provision for the FAIR Plan itself covering what would ordinarily be reinsured catastrophe losses. It made a difference in the previous filing. It makes very little difference in this filing, and my expectation is that it's negligible and that it's covered, in a sense, by the excess of the current members equity, roughly, what is it, $240 or $280 million excess of the attachment point of $200 million.

So my adaptation for this particular filing, because of the very full reinsurance program, is that I don't have to allocate. And if we look at the exhibit, the allocation is zero that goes to the cat losses borne by the FAIR Plan. And so the same ratio that's for ordinary losses is used as leverage for all the losses.

I'm not sure that explains it exactly, but that's the point. It would come into play if there were lots of holes like there was in 2009, because the FAIR Plan is bearing the risk, not the reinsurers. But here, the reinsurers are bearing almost all of the risk, from the attachment point to the limit.

Q. I'll just read it adding a word in and maybe that -- because I don't know that I understand your answer to have met my question.

"Therefore, members act as reinsurers for these expected losses" -- I'm with you there with what you're advocating -- "and" members "allocate an appropriate level of capital to underwrite these expected losses." That's where my question is. The members are allocating that, or are you saying the FAIR Plan is allocating that?

A. Well, actually -- it's because -- unfortunately, the accounting and everything else is not surplus, which we could carry through, but it's members equity. And so that's what I'm really referring to. And I'm referring to allocating the members equity to covering either the ordinary losses plus the cat losses under the attachment, versus allocating some capital held by the FAIR Plan to holes in the reinsurance program. They have to be treated like they are, you know, riskier losses.

Q. In the world of non-residual market entities -- so we have a homeowners insurer that's a private company that writes voluntary insurance -- are choices sometimes made of either increasing

capital or, in the alternative, buying more reinsurance, in your phrase, to rent the capital?

A. Yes. Yes, they have -- I mean, voluntary companies have that choice. They also have the choice, if they're in a group, of having another member of the group be the reinsurer to yet another member of the group. There are all sorts of ways of dealing with facing catastrophic risk.

Q. So in the case of the FAIR Plan, there would be -- people could have a discussion of, should we assess our members or should we buy reinsurance if we feel we don't have enough capital?

A. Well, my understanding is that the assessment process is always there for excess losses from the FAIR Plan, and that it's a matter of the operation of the FAIR Plan as to how much of the members equity, even though they own it, is retained for operating purposes and is put at risk for writing the residual market policies.

PRESIDING OFFICER SUMNER: Okay. Thank you.

PRESIDING OFFICER FARRINGTON: Mr. Meyer, do you have redirect?

MR. MEYER: I have about ten questions on redirect. I'll do whatever the parties and the

Hearing Officers want.

PRESIDING OFFICER FARRINGTON: Well, if anybody wants food in this building, we've got to go right now.

MR. MEYER: What I'm saying is, I would like to accommodate the Hearing Officers and parties. If you want to do it now and get it done, we can do that. If you want to take a break, we can do that.

PRESIDING OFFICER FARRINGTON: What's --

MS. MORAN: Finish up.

PRESIDING OFFICER FARRINGTON: Finish up? Okay. Would you like a short break in the middle or just --

MR. MEYER: No.

REDIRECT EXAMINATION

BY MR. MEYER:

Q. Dr. Derrig, I'm going to ask you first to turn to Page 1170 of your filing, please.

A. Easier said than done. Here we are.

Q. You were asked several questions by Ms. Moran about why FAIR Plan rates should have certain costs in them. Do you remember that area of questioning?

A. Yes, I do.

Q. Do you see Principle 1 and Principle 2 on Page 1170?

A. Yes.

Q. Do you agree with those two principles?

A. (Reviewing document) Yes.

Q. Principle 2, would you read it into the record, please.

A. Principle 2 is "A rate provides for all costs associated with the transfer of risk. Ratemaking should provide for the costs of an individual risk transfer so that equity among insureds is maintained. When the experience of an individual risk does not provide a credible basis for estimating these costs, it is appropriate to consider the aggregate experience of similar risks. A rate estimated from such experience is an estimate of the costs of the risk transfer for each individual in the class."

Q. Does Principle 2 convey the idea that reinsurance costs incurred by the FAIR Plan to reinsure FAIR Plan risks should be included in the FAIR Plan rates as opposed to voluntary insurers' rates?

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A. Yes, in the sense that the principle is that the people in the class that are insured as individuals should be the same as the appropriate class upon which the rates are based.
Q. Would it make any sense, Dr. Derrig, in your opinion, to assert that half of all FAIR Plan losses should be taken out of FAIR Plan rates and put into voluntary insurers' rates? Does that make any sense?
A. I'm not sure what you're saying. Are you saying that they -- the voluntary insureds in the FAIR Plan should pay some of the losses or should --
Q. I'll move on. Hearing officer Sumner at the very end asked you a question about the use of the IRR model in voluntary auto insurance rates. Do you remember that?
A. Yes.
Q. And you said that the IRR model had been used in fix and establish for Mass. auto; is that right?
A. That's correct.
Q. Has it also been used for voluntary filings by individual Mass. auto companies in competitive rating?

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A. Yes. I know of the use of it in the actual first transition to competitive rating. Subsequent to that, I don't know, but I assume they still continue to use it, and I do know that it's used in the MAIP rates.
Q. And MAIP would be a residual market; is that correct?
A. That's correct.
Q. Moving on to the area of contingency, you were asked several questions about contingencies by both Ms. Moran and Mr. Leight. Do you remember that?
A. Yes.
Q. Let me make sure I understand on the record what you were saying there. Are you saying that if losses and expenses and reinsurance costs and all other elements of costs are estimated correctly in the rates, that in that case, you do not need a contingency?
A. Right.
Q. But conversely, are you saying that if someone is cheating when they set rates by setting a loss provision too low or setting the reinsurance cost provision too low or the hurricane provision

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too low, then you would need a contingency provision in rates?
A. Well, I guess sort of by definition. What's supposed to be in rates is the actual expected cost, and if you deliberately put something in less, then the only way to get back to the true cost is to add a contingency factor.
Q. And by not adding a contingency factor in your underwriting profit calculations, your underwriting profit calculations are assuming that all other elements of the rates are set correctly; is that right?
A. That's right.
Q. Now, you were asked a question about what would happen if you set the debt percentage of the capital structure at zero. Do you remember that question?
A. Sort of, yes.
Q. If you hold everything else constant, and you change the equity/debt ratio from 80/20 to 100/0, would that move up your cost of capital?
A. Yes, it would.
Q. And all else equal, will that move up your underwriting profit provision?

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A. Yes.
Q. You were asked a question by Mr. Sumner in the answer to which you referred to a zero being used in an allocation. Could I ask you to turn to Page 1160 of your filing, please.
A. Yes.
Q. Do you see on Page 1160, Column 3, you have zeros in that column; is that right?
A. That's correct.
Q. Is that the zero you were referring to when you answered Mr. Sumner's question?
A. Yes.
Q. And particularly, is what you're doing here on Page 1160, where you're setting that Column 3 equal to zero, is you are saying there are not enough or large enough holes in the reinsurance purchase to allocate the reinsurers' type leverage to the FAIR Plan?
A. That's part of it. The other part of it is that the members equity is larger than the attachment point. And one of my assumptions for saying that -- the FAIR Plan, as it stands right now, can cover the little holes that are there with the excess that they hold in members equity over the

attachment point.
Q. Now, if you were to attribute any of a reinsurance company-type reserve-to-surplus ratio, that is, the 0.88 shown in Column 4, that would move down the reserve-to-surplus ratio; is that right?
A. Correct.
Q. And all else equal, that would move up your indicated underwriting profit provision; is that correct?
A. Yes. And in particular, in the case where there was no reinsurance, there would be a very large weight in Column 3 to the reinsurers' leverage ratio, because the FAIR Plan would be covering everything.
Q. For the amount of hurricane risk above the $1.2 billion exhaustion point for the current program, is there any compensation, in your profit calculations, for that risk?
A. No.
Q. If one were to put into your underwriting profit provision calculation some compensation for that risk, all else equal, would that move up your underwriting profit provision?
A. Yes.

Q. Mr. Leight asked you a question about 2006 through 2010 rates having a zero underwriting profit provision in them. Do you remember that question?
A. Yes.
Q. Is it true that current rates have a positive underwriting profit provision in them, if you know?
A. Well, I think it came out that it was a negotiated settlement, and therefore -- I'm not privy to what the negotiation was. I don't know what was retained. In theory, there's a profit provision in the negotiated settlement.
MR. LEIGHT: I would object to that answer. I mean, if we want to, we can bring in the settlement, but the settlement was quite clear that none of the aspects of the rate in the settlement are admissible in any other proceeding, as these things always are.
So to the extent Dr. Derrig is testifying about that and attempting to place that in the proceeding, I would object to that and move to strike it.
MR. MEYER: In response to that, it was precisely for that reason I was so surprised by Mr.

Leight's question on that topic. He was the one that claimed or tried to put into evidence the idea there was a zero underwriting profit provision in the current rates. The statement was incorrect. I'll leave it where it is, if you wish.
MR. LEIGHT: I did amend the question to exclude the stipulated settlement.
PRESIDING OFFICER FARRINGTON: Right.
BY MR. MEYER:
Q. All right. Moving on, Dr. Derrig, could I ask you to turn to Page 1085, please. This is a subject that Mr. Leight asked you about.
A. I have it.
Q. Do you remember Mr. Leight asking you what would happen if you put zeroes in Column 6a and did nothing else, Dr. Derrig?
A. Yes.
Q. Would putting zeroes in Column 6a and doing nothing else be intentionally modeling this transaction incorrectly?
A. Yes.
MR. MEYER: Thank you. No further questions.
MS. MORAN: Just one.

RECROSS EXAMINATION
BY MS. MORAN:
Q. Dr. Derrig, in the case of a traditional insurance company and their investors, and there are investors, should the traditional insurance company run out of funds to pay claims -- run out of surplus, excuse me, to pay claims, the investors are out of luck in that situation, correct? There is no one they can assess if the company runs out of money to pay the claims that are outstanding?
A. If they run out of money, meaning their surplus goes to zero?
Q. Correct.
A. Then it depends upon, you know, the situation with guaranteed funds, et cetera, of who pays claimants.
Q. They can't go back against their investors; they can't ask their investors for any more money?
A. Not that I know, but I'm not familiar with how the laws go.
Q. And in the case of the MPIUA, if they had the misfortune to run out of money totally and not be able to pay claims, they can assess their members? You, I believe, referred to the member

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companies as investors?
A. Right.
Q. So would you agree that that is a significant difference between the traditional insurance market and the MPIUA, just that ability?
A. Well, it is, but -- I mean, in general theory, and actually in the real world, the consumers, the buyers of insurance receive a slightly lower premium because of the option to default; that is, in theory it should cost less to an insured because the company they're insuring with may not pay all the claims. And so that's an option that's held by the company. And in general literature, research literature, it has been shown that the prices reflect the fact that they don't necessarily pay everything.
So when you buy the insurance, you get a slight reduction if it's a company, and that would be reflected in this filing by the fact that we have an assumption that every claim is paid, whether it's through what the members equity can pay with the premiums, or it's an assessment. But we assume this is fully guaranteed.
Q. Given all that -- I'll go with what you

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said, but there still is that difference in the mechanism; one mechanism is there in the MPIUA to go back and assess their members, or investors as you call them --
A. Right.
Q. -- additional monies to pay claims. That mechanism -- and we won't go -- thank you, but the effect of that mechanism we won't go to. The mechanism does not exist for the traditional insurer to go back and assess their investors -- they have other means to address this, but they cannot go back and assess their investors?
A. Right. But I'm saying --
Q. I understand --
A. -- that's reflected in their prices.
MS. MORAN: Thank you.
RECROSS EXAMINATION
BY MR. KLIBANER:
Q. Dr. Derrig, just a couple of questions. You just testified, if I heard you correctly, that in your IRR model, if there was a zero debt weight, the profit provision would go up; is that correct?
A. I'm sorry. If there were what?
Q. A debt weight in the debt/equity ratio of

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zero --
A. Yes, because the cost of capital, the weighted cost of capital would be higher with a zero debt.
Q. And if the ratio was 100 percent, 100 percent debt as the structure of capital, would the profit provision go down?
A. Yes.
Q. Now, on Page 1170, you had testified about Principle 2.
A. Principles 1 and 2, Page 1170.
Q. And in Principle 2 there's a reference to the transfer of risk?
A. Correct.
Q. Is this talking about the transfer of risk from the insured to the insurer?
A. Yes.
Q. In the situation of reinsurance purchased by the FAIR Plan, is the transfer of risk from the member companies to the reinsurers?
A. Yes, but it's on behalf of the insureds too.
Q. Did the insureds participate in the process of deciding whether the FAIR Plan would purchase

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reinsurance?
A. Well, in effect they do, yes.
Q. How do they do that?
A. Because they are insureds with the FAIR Plan, and they -- once you sign up that way and, I guess, not be uninsured, that you, just like a voluntary company, you accept all of their operations of the business. I mean, you buy an insurance policy from a particular company, and what you're buying is the ability to pay the claims under that policy, with all the other things that go on with the company.
Q. Is it your understanding that policyholders, when they purchase a policy from the residual market, the FAIR Plan, that they are voluntarily agreeing to the reinsurance program that the FAIR Plan has?
A. No, I'm not saying that.
Q. What is it that you're saying, then, in terms of how the insureds participate in the reinsurance program of the FAIR Plan?
A. That they're the benefit of the risk reduction in having reinsurance in their rates. That's all. But you were asking more like

government, governing questions of whether individual policyholders can effect purchases of reinsurance. And my answer tried to say that if you're in a voluntary market, you accept the operations of the insurer that you place your policy with. You don't generally have rights to tell them how to operate. That's what you're purchasing.

Q. And in that residual market, policyholders cannot tell the FAIR Plan how to structure its reinsurance program?

A. I don't think so.

MR. KLIBANER: Thank you. No further questions.

MR. MEYER: Nothing further. Thank you.

PRESIDING OFFICER FARRINGTON: Thank you, Dr. Derrig.

MR. MEYER: Before everyone goes, we need to schedule Mr. Ericksen's testimony.

(Discussion off the record)

(Whereupon the hearing was adjourned at 2:10 p.m.)

C E R T I F I C A T E

I, Carol H. Kusinitz, Registered Professional Reporter, do hereby certify that the foregoing transcript, Volume II, is a true and accurate transcription of my stenographic notes taken on February 28, 2012.

Carol H. Kusinitz

Carol H. Kusinitz
Registered Professional Reporter

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