LOSS COSTS, RATING BUREAUS AND THE WORKERS COMPENSATION CRISIS (CAS CONVENTION, 11/90)

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"<u>Loss Costs, Rating Bureaus and the Workers Compensation Crisis</u>"

By Richard A. Hofmann, ACAS, MAAA

In a recent column in the <u>National Underwriter</u>, the new President of the NCCI, Bill Hager, predicted a "meltdown" of the <u>private</u> workers compensation insurance industry within the next two years unless significant changes take place. Bill did an excellent job of detailing a variety of reforms that are needed in the benefit delivery system and the claim adjudication process, but I believe the likelihood that all of these changes can be implemented in the next two years is not good. However, I believe there are some other changes, which Bill didn't mention, that could have a significant impact on alleviating the crisis in a short period of time. These changes, which relate to regulation and the role of rating bureaus, could be implemented fairly quickly because Bill Hager is both a former insurance commissioner and the kind of guy who can make things happen. The time to act is now, but the key question is, will Bill be able to overcome "institutional gridlock" at the NCCI, and receive sufficient support from his member companies, to make the internal changes necessary to avert a "meltdown" in 1992.

The NCCI has recently made a commitment to filing advisory loss costs, instead of advisory rates, in many states. This voluntary action was taken in response to the activities of an NAIC committee studying workers compensation advisory organizations. To some, this is a significant change. To others, this is just the first step in a series of rating bureau reforms that are badly needed to bring down the government controlled administered pricing system and replace it with a free market system. If the Berlin wall can come down almost overnight, then there's hope for the private workers compensation insurance industry.

In the fall of 1989 ~~Last Fall~~, I was asked to testify before the NAIC committee studying rating bureau activities by its chairman, Bill McCartney. Bill wanted me to discuss a report which I had prepared for Bill Hager, then Insurance Commissioner in Iowa, recommending a new form of regulatory environment which was designed to help solve the workers compensation insurance crisis in that state. This proposal called for a prohibition on the publication of both advisory rates and loss costs.

To help the regulators understand why the publication of advisory rates and loss costs should be prohibited, I asked them to consider the question, what is the proper role of a rating bureau, especially the NCCI, in the workers compensation marketplace today? In my NAIC testimony, I identified six distinct functions which are currently performed by rating bureaus:

1. Maintenance of a statistical plan and collection of data.

2. Conversion of historical exposure and loss data into ultimate loss costs and projection of ultimate historical loss costs into the future in total and by class.

3. Conversion of expected loss costs into classification rates by inclusion of expense and profit provisions.

4. Development of rating plans to adjust manual rates based on individual employer characteristics.

5. Promulgation of experience modifications.

6. Administration of the residual market mechanisms.

So rating bureaus are statistical agents, data processing firms, actuarial advice organizations (i.e. consulting firms), and reinsurance pool administrators. Because residual market pool administration was excluded from the NAIC committees study, my testimony focused on the following questions:

1. Does the workers compensation marketplace need statistical agents?

2. Does the workers compensation marketplace need advisory organizations to publish advisory loss costs?

3. Does the workers compensation marketplace need advisory organizations to publish advisory rates?

My answers were: Yes, Maybe and No. Let me explain.

Statistical Agents

Does the workers compensation marketplace need statistical agents or data collection agencies? Definitely, yes. Without industry aggregate exposure and loss data, new insurers (like my company) would face a significant barrier to entry. The collection of aggregate and individual employer loss data fosters competition by allowing insurers to intelligently price their product.

While traditional wisdom calls for a uniform statistical plan and classification definitions, it may in fact be more appropriate to allow different statistical plans with varying degrees of detail for different types of employers. For example, ever since most states converted from limited to unlimited payroll as the exposure base, the construction industry has been claiming that total payroll is unfairly discriminatory and that hours-worked is the most appropriate exposure base for their classifications; however, the insurance industry has been reluctant to collect the data needed to resolve this issue for much the same reasons that they went to unlimited payroll in the first place. My point here is that data collection agencies should be responsive to the interests of insurers and consumers (and regulators for that matter).

As another example, it may be desirable to have fewer classes, i.e. classes based on the nature of an employers business, than we have presently and collect additional data on other rating variables related to territorial differences, size of employer, and other considerations that may be shown to have a correlation with workers compensation costs. The existence of an aggregate industrywide database enhances competition by allowing insurers to accurately allocate the overall costs of the WC system to the individual employers or groups of employers that incur the losses. This database should be preserved, and enhanced, to promote <u>responsiveness</u> to the changing environment and <u>innovation</u> in actuarial research.

<u>Advisory Organizations - Development of Advisory Loss Costs</u>

Does the workers compensation marketplace need advisory loss costs? Maybe. Theoretically, the availability of statewide loss and exposure information should be sufficient to allow insurers to price their product. However, as a practical matter, some insurers do not have the budget or resources to convert reported historical data into ultimate loss costs and then project these loss costs into the future. Competition is enhanced and economies of scale are achieved by the existence of advisory organizations which can perform the necessary calculations and publish advisory development factors, advisory trend factors, or even advisory loss costs by class on a subscription basis. However, there are several key considerations related to advisory organizations in this context:

1. To promote actuarial research and innovation in general and to encourage the development of additional markets for traditionally non-competitive market segments. It may be advisable to allow for the existence of several advisory organizations.

2. The functions of advisory organizations and statistical agents are <u>separable</u> and need not be performed by the same organization. All advisory organizations should have equal access to the database and no advisory organization should exclusively control what data is collected.

3. Current rating bureau meetings are not open to all interested parties. As a matter of logistics, the small and medium-sized regional insurance companies, and even some of the larger national companies based in other parts of the country, find it prohibitively expensive to consistently attend the rating bureau meetings. At the same time, most rating bureau by-laws prohibit these companies from sending other individuals to collectively represent them at these meetings.

   Committees play a significant role in setting policy at rating bureaus. In light of the demographic makeup of these committees, a key question is, should these committees be allowed to control what loss costs should be filed, what ratemaking procedures should be used, or which state's filing should be prepared first? Should committees be allowed to vote at all, or should they simply be available as a sounding board for advice? If the latter, then why shouldn't rating bureau meetings be open to all knowledgeable parties?

In conclusion, no, advisory organizations are not absolutely necessary, but yes, in the interests of efficiency and cost savings for the entire system, competition is enhanced and economies of scale are achieved by their existence. However, there is no reason why the advisory organization and statistical agent have to be the same entity.

Advisory Organizations - Development of Advisory Rates

Does the workers compensation marketplace need advisory rates? Simply, no. In the spring of 1989, the NAIC recommended that rating bureaus should not be permitted to publish advisory rates. It is not clear why workers' compensation was exempted from this position. I have read through all the testimony from the hearings of the NAIC Working Group, and frankly, I am still not convinced that workers' compensation should be treated differently from any other line of insurance when it comes to publishing advisory rates. To expand, a rate can be viewed as consisting of three components; a loss component, an expense component and a profit component. I have just discussed the loss component in terms of advisory loss costs. The generation of advisory rates amounts to taking advisory loss costs and loading them for the expense and profit components. To understand why I strongly support data collection agencies and also support (though less strongly) their publication of advisory loss costs, but do not support their publication of advisory rates, it is important to understand that the loss component of the rate is by far the hardest to estimate, and is largely beyond the control of the individual insurer. Moreover, insurance is different from most other products in that the primary cost (i.e., the loss component) <u>is not known</u> until long after the product is <u>sold</u>. Thus, pooling of loss experience is essential to reduce the uncertainty in this component and is actuarially appropriate.

With respect to the expense component, insurance is really no different form any other product. These costs are relatively predictable for each individual company, and furthermore, can vary substantially from company to company. So industrywide average expense provisions are inappropriate for individual company ratemaking purposes.

The collection of industrywide expense data in and of itself is not an issue. This data is readily available in publications of the A.M. Best Company. The issue is the publication of benchmark expense provisions for ratemaking purposes, when there is generally no actuarial need to pool industrywide expense data in projecting future costs for a given type of expense. Many insurers tend to rely on benchmark expense provisions as a crutch, without necessarily reviewing the benchmarks to see if they make sense for their own operations.

With respect to the profit component, this is a subjective element, in that it encompasses each individual company's <u>own</u> profitability goals, its own investment portfolio and its own competitive strategy. Industrywide profit provisions are thus inappropriate for individual company ratemaking purposes.

All of these comments on the development of advisory rates apply equally to any line of insurance. Workers' compensation is no different than any other line in this regard. The rest of my testimony dealt with competition in the marketplace and the various tools used by insurers to compete for business. It points out that while the marketplace is competitive, this competition is most intense for large accounts. In all but the competitive rating states, small employers encounter very little price differentiation in the marketplace. Since the vast majority of employers are small, most employers view the workers compensation marketplace as a monopoly. In my testimony, I called for a variety of changes in rating bureau practices and work products, including a ban on all mandatory bureau rating plans. While space does not permit me to discuss these issues in detail, a complete copy of my testimony may be obtained from the NAIC.

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How does this testimony relate to the workers compensation insurance crisis?

For some time now, Gary Countryman, the President and CEO of Liberty Mutual, has been calling for the formation of a "national advocacy organization" that would have workers compensation reform as its single most important interest. I think, without question, the National Council on Compensation Insurance (NCCI) should be that organization. However, before the NCCI can be successful in this role, it would seem that some reform is necessary. I suggest that the Iowa proposal serve as a blueprint for these reforms.

I believe rating bureaus bear significant responsibility for some aspects of the workers compensation crisis: flaws in the classification ratemaking process, mandatory and overly rigid experience rating plans, and poorly administered residual market pools all contribute to the crisis. I would like to challenge the insurance industry to re-evaluate the role of rating bureaus and consider limiting their role to the establishment of standardized policy forms, the promulgation of a statistical plan, and the collection and dissemination of both individual risk and aggregate industry historical data. I suggest that each state should have its own workers compensation database, with the NCCI serving as an umbrella organization promoting policy form and statistical reporting consistency between states and performing research on the underlying causes of cost trends around the country.

Presently, too much time, energy and resources at the rating bureaus are absorbed by the promulgation and defense of industrywide rate filings. I believe the workers compensation system would be much better served if rating bureaus got out of the "actuarial advice" business and focused their efforts on the publication of high quality actuarial data, i.e. better data than what we have today. If ISO follows suit, the pressure to repeal

McCarran-Ferguson should dissipate significantly.

The publication of prospective cost estimates (like advisory rates or loss costs) by an organization owned by the insurance industry and controlled by its largest members is clearly unacceptable from an anti-trust perspective because judgmental decisions, i.e. advice, is required. The insurance industry cannot brush off the monopolistic and anti-competitive appearance of these activities. Why not let the leading consulting firms publish, on a subscription basis, advisory loss costs for insurers to use based on data collected by statistical agents? Frankly, I think the existence of competing "advice" firms may lead to new, innovative ways to price workers compensation.

I am calling on the insurance companies which govern the rating bureaus to take a hard look at rating bureau activities. Why does the industry let one organization make rate filings on behalf of all insurers, when these filings are easy targets for intervenors and so called "consumerists" to attack? Wouldn't insurers rather have better, more current actuarial data from which to make appropriate pricing decisions on their own? If some insurers don't have the resources to make these decisions, why don't they let an independent consulting firm do it for them rather than their competitors? Insurers can't be expected to make rate filings based on their own loss data, but if industrywide loss data is available and insurers are forced to make rates using their own expense assumptions and actuarial judgments, then there will be more price differentiation in the marketplace and potential intervenors will be less likely to contest rate filings.

Furthermore, if statistical agents can focus their attention on producing better actuarial data and researching the underlying causes of cost trends, then regulators and legislators will work with them (instead of against them) and the need for double digit rate increases in the future could be alleviated. I believe the Model Data Reporting Bill recently passed by the NAIC is counterproductive and not the answer to our problems. Claims administrators need to spend more time on cost containment rather than entering more data into the computer. Most of this data is already supplied to the workers compensation agencies, so they should be responsible for coding the data.

I have a high regard for the many talented people that work at the NCCI and other rating bureaus, and it is in my company's best interest that these organizations survive and thrive. I'd like to work with the NCCI to help avert the meltdown that Bill Hager has predicted. While I realize that these comments will not endear myself to the NCCI's senior management, I do ask that they and their member companies open up to some new ideas and different perspectives, and at least think about what I have had to say.