SHOULD THE COMPENSATION PREMIUM REFLECT THE EXPERIENCE OF THE INDIVIDUAL RISK?

BY

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Experience rating of compensation risks as hitherto employed might be defined as the predication of the current rate for a given risk upon a consideration of the past experience of such risk. This practice has been confined almost entirely to cases where the insurance carrier intended to show that the rated risk had for some time past an accident experience better than the average (where an average experience means an experience productive of a cost corresponding to the basic pure premium). It is not surprising that virtually no risks have suffered an increase in rate through experience rating, since up to this time it has been customary that the request for such rating proceed from the insurer. Moreover many employers whose experience would entitle them to a decrease in rate, have not availed themselves of this advantage because of their unfamiliarity with the possibilities of the experience rating plan.

Although experience rating has been from time to time commented upon in these pages, it may not be untimely, in view of the attention now being accorded this plan in several states, to present the following summary of the principal

OBJECTIONS TO EXPERIENCE RATING.*

1. In case of small risks past experience even for a considerable period, and even if physical conditions remain stationary, is no true measure of hazard since the payroll exposure is too limited to yield a reliable pure premium.

2. Although a few large risks exhibit a payroll exposure sufficient to make even a brief experience quite significant, changes in mechanical process and in types of machinery used take place so frequently as to greatly invalidate past experience as an index of current hazard.

* The material embodied in this summary of objections to experience rating is in part due to a memorandum entitled "Experience Rating," issued by Mr. Walter S. Bucklin.

3. Safety measures, safety organization and physical conditions are believed by many to constitute a better guide to "moral hazard" than does past experience.

4. Experience rating as we have known it places the carrying company in a position to "hold the business" against all competition; this because the carrier has in its office the only records upon which an experience rating can be based.

5. Experience rating has resulted in a material reduction in the aggregate premiums collected from the risks to which the plan has been applied. Mr. Senior's helpful paper in the *Proceedings* (Vol. I, page 237), showed that in New York during the first year of the present compensation law 230 experience rated risks exhibited a net premium decrease of nearly $78,000 which was over 24 per cent. of the premiums upon such risks as estimated at manual rates. As Mr. Senior pointed out, such tremendous shrinkage in premiums was not contemplated when the minimum adequate rates were computed. Moreover, it would appear to be inequitable that where better than average risks are written below manual, worse than average risks are not written above.

6. The business of insurance is based upon the principle that the assured shall pay a premium commensurate with the à priori probability of loss. Experience rating is an outright departure from this principle, since it permits the premium to be influenced by the individual experience of the assured.

7. By placing the actual rate-making power in the hands of the insurance carrier, experience rating weakens the ability of state officials to enforce adequate compensation rates.

8. In some instances the employer in his anxiety to exhibit a favorable experience has brought pressure to bear upon the employee to prevent his claiming compensation. (See the report of the American Association for Labor Legislation entitled "Three Years under the New Jersey Workmen's Compensation Law.")

The Industrial Commission of Colorado was moved by the foregoing considerations to rescind its approval of the experience rating plan on October 14, 1915. From a memorandum of the New York State Insurance Department dated February 17, 1916, it appears that the New York Department does not favor experience rating as practiced hitherto. However, in the same memorandum (from which we hereinafter quote), it is suggested that in compensation underwriting, it might be possible to employ

THE PRINCIPLE OF DEDUCTIBLE AVERAGE.

Since "the Workmen's Compensation Law of New York requires the employer to insure his entire compensation obligation . . . it is perhaps not feasible at this time to issue deductible average policies." Instead the Department's memorandum outlines a plan under which "every employer would pay a fixed rate for losses in excess of some fixed amount (say $50 or $100 each). In addition he would pay $50 or $100 as agreed upon, for each loss sustained during the policy term."

"This method of rating can be made applicable to much smaller risks than any method which seeks to penalize the employer for serious accidents or to reward him for their absence. The retroactive application of the plan is logical as well as defensible. It serves to adjust the premium upon the basis of conditions which have obtained during the period for which the premium was paid, instead of applying past experience as the measure of cost for a period of unknown experience which in all probability will not be identical with the past. Finally, such a system holds out to the employer an incentive for the prevention of accidents in terms of real money which he cannot fail to understand. The point we wish to emphasize is that our present plan begins at the wrong end and if properly applied would have the effect of throwing the burden of heavy losses upon the employer."

Successful application to small risks, justice to the assured and an added incentive toward accident prevention appear to be the Department's claims for the proposed plan. The first paragraph of the memorandum contains these words: "We believe it is possible to develop an experience rating plan which may be superior to schedule rating." The natural implication is that the suggested plan, which for brevity we shall term the "deductible average" scheme, is considered something of an improvement upon the schedule-rating plan.

It was suggested in the Department's memorandum that every employer pay $50 or $100 as agreed upon "for each loss sustained during the policy term." I am in some doubt as to whether it is meant that the employer should pay an additional sum for each compensated accident or for each accident resulting in payment of compensation or medical cost. It is essential that the basis for premium adjustment be such as not to encourage disputes and liti-

gation between the carrier and the assured. In New York and many other compensation states every compensated accident is a matter of public record. On the other hand, accidents resulting in medical cost only are not always brought to the attention of the industrial commission. Offhand, it would appear quite impracticable to collect an additional premium for every accident resulting in either compensation or medical cost.

Is the Deductible Average Plan Feasible?

Let us consider therefore the practicability of an arrangement whereby the assured pays, in addition to a fixed percentage of his earned payroll, $100 for each accident occurring within the policy term resulting in death or weekly compensation.

From the very timely paper* by Mr. Joseph H. Woodward at the last meeting of this Society, we learn that (exclusive of medical aid) the incurred loss per compensated accident was $263.45 in the experience of the New York State Insurance Fund for the year ending June 30, 1915. From the same paper, it appears that medical cost represents 16.6 per cent. of the total compensation cost. Total incurred loss per compensated accident (including medical cost) would be therefore $263.45 ÷ .834 or $316. On the same basis, assuming 35 per cent. to be an appropriate expense loading for New York compensation premiums (in accordance with the recommendations of the recent conference on rates), we conclude that to pay current losses, set aside sufficient reserves and meet expenses, $316 ÷ .65 or $486 must be collected for each accident compensated in accordance with the provisions of the New York law.

Although it is the general impression that the risks underwritten by the New York State Insurance Fund are, on the whole, somewhat more hazardous than the average, this belief should not be given undue weight.† Assuming then for purposes of argument that ap-

* *Proceedings*, Vol. II, p. 196.

† In fact, in computing a reduction in present rates because of the deductible average feature, it would appear essential that the experience of the carrier showing the highest incurred loss per compensated accident be taken as a guide; at least this would be so as among all carriers employing the same schedule of rates. As the New York State Insurance Fund is not using the same manual of rates as the private carriers, from the standpoint of the companies it would be better if we could base our analysis upon the experience of one of their own number. Since the fund is one of the largest New York carriers and since its incurred losses have been computed

proximately $500 per compensated accident would yield adequate premiums for New York, we are forced to the conclusion that an additional premium of $100 per compensated accident would not justify a greater reduction than 20 per cent. in present New York rates, if present rates are adequate, but not redundant.

There is a very good reason why the plan we are discussing if adopted at all should be made to apply to all compensation risks or to all risks exhibiting annual payrolls or annual premiums within certain specified limitations. It is clear that the experience of certain risks will exhibit a higher cost per compensated accident than the average cost per compensated accident for the classification. Now, it seems likely that in the long run such risks, to whom the deductible average plan would be an advantage, would elect the plan in greater proportion than would employers whose experience shows a relatively low cost per compensated accident. In other words, the deductible average plan, if optional, would open the way to self-selection of risks to the great financial disadvantage of the carrier, since the reduction in rate, on account of the additional premium collected, would at present at least have to be predicated upon the experience of all employers.

Assuming the selection of the plan is not within the option of the employer, the following appear to be objections thereto:

1. Any innovation in compensation underwriting should be attractive to the assured unless it be of real advantage to the carrier or essential from the standpoint of public policy.* I doubt whether many employers would elect to be assessed $100 for each compensated accident in return for a reduction of 20 per cent. in present premiums. Very many employers would, in my opinion, actively oppose the adoption of such a scheme.

upon a scientific basis, its experience may well be considered of great general value. As to the outline of the fund's method of computing incurred losses, see Mr. Woodward's paper in the *Proceedings*, Vol. I, p. 112.

* The above discussion has the New York schedule of benefits as its basis. Since this schedule is perhaps the most expensive of any American scale of benefits, it should be noted in all fairness that in certain other compensation states an additional premium of $100 per compensated accident might justify a reduction of as much as 35 per cent. in present premiums, arguing as in the above from the first year's experience of the New York State Insurance Fund with regard to incurred loss per compensated accident. An additional premium of $50 per compensated accident would not appear to justify a reduction in compensation premiums sufficient to be worth considering.

2. Far from being a boon to the small risk, the plan would apparently work grave hardship to many employers of comparatively small means. Several additional premiums of $100 would well nigh drive many small establishments to the wall. The insurance carrier would probably find itself in a by-no-means enviable position with respect to the collection of these same additional premiums.

3. Many enterprises are conducted upon so narrow a margin as to make it a matter of prime importance that the current expenses be determined with reasonable accuracy at the beginning of the financial year. This situation is by no means confined to small establishments. The proposed plan would make the compensation premium an uncertain quantity not determinable in advance.

4. It was suggested in the Department's memorandum hitherto quoted that the proposed plan would create an added incentive toward accident prevention and this claim seems to be not without foundation. On the other hand, even this great justification for the scheme is outweighed if its adoption sets in motion a tendency to discourage the employee from availing himself of his rights under the compensation law. Where it means an outright loss of $100 to the employer to have his workman remain away from duty one day over the waiting period, it is, I fear, too much to expect that some employers will not bring undue pressure upon the employee to the end that he return to work at an early date or conceal from the insurance carrier and the industrial commission the true date of return. The extent to which abuses of the nature suggested might develop under the deductible average plan is now of course a matter of conjecture. However, it would appear to be contrary to public policy to inaugurate a scheme which would create a strong economic incentive toward practices inconsistent with the spirit of the workmen's compensation law.

Apparently a plan involving the true deductible average principle whereunder the employer would bear the actual loss up to a certain maximum would be open to all of the foregoing objections in greater or less degree; and the original experience plan exhibits many disadvantages from the standpoint of the underwriter as well as being somewhat incompatible with the spirit of the compensation acts. Is there any form of experience rating more defensible than the types we have discussed?

A type of rating system has been suggested which might be briefly defined as

RETROACTIVE EXPERIENCE RATING OF ALL LARGE RISKS.

It is proposed that *all* risks whereunder the earned yearly premium at manual or schedule rates is in excess of a certain amount, say $5,000, be experience rated and that the reduction or increase in rate be made at the end of the insurance period upon the basis of a scientific evaluation of the experience during that period. It may at once be stated that this modified plan is infinitely less objectionable than experience rating as we have known it, principally because reductions in rate for good experience will be balanced by increases in rate on account of unfavorable experience. I feel, however, that it would be unwise to adopt even this modified plan for the following reasons:

1. The carrying company or fund will still have an undue competitive advantage. This advantage would arise from its possession of the experience record of the assured. Skilled supervision on the part of a central rating board might do much to prevent actual manipulation of the experience record; the possibility of such manipulation would, however, still loom large in the eyes of the assured.

2. The very fairness of the modified plan would make it most unpopular. The experience of most employers affected by the new plan will undoubtedly exhibit a material fluctuation in compensation cost from one insurance period to another (see paper of Albert H. Mowbray, *Proceedings,* Vol. I, p. 24). One year the assured will receive a most gratifying dividend—the next year the shoe will be on the other foot, and the dividend will be a negative quantity, resulting in a most unsatisfactory item of disbursements not contemplated at the beginning of the fiscal period.

As far as the employer is concerned the real demand for experience rating up to this time has arisen from a desire to get insurance at better than average cost. It is true that the new plan will permit the employer with a consistently favorable experience to still realize his ambitions in this regard. The employer whose experience is unfavorable will, on the other hand, find the cost of his insurance increased; and in my opinion, he will complain to such good effect that carriers and supervising authorities alike will be most happy to discontinue the experience plan altogether.

3. It seems to me that any form of experience rating whatever holds up to the employer an economic reward for the prevention of

compensation claims. *The unscrupulous employer may achieve this reward not so much by accident prevention as by discouraging the employee from availing himself of his rights under the compensation law.*

Now in compensation insurance the terms "loss prevention" and "accident prevention" are not synonymous,—and before drawing our final conclusions it may be well to elaborate this point.

In fire insurance, it is clearly consistent with public policy to work directly toward the prevention of financial loss.

From the standpoint of the community it is immaterial whether this loss prevention takes the form of restriction of combustion or prevention of ignition. Since combustion imposes a direct loss upon the assured under a fire insurance policy, we need fear no tendency upon his part to minimize the amount of loss in dollars and cents.

In compensation insurance the occurrence of the accident corresponds roughly to the fact of ignition, while the seriousness of the injury corresponds to the extent of combustion. At this point the analogy stops, for the compensation loss is sustained in the first instance not by the assured himself, but by a third person, viz., an employee. Where the employer carries his own risk, or where under a compensation policy he knows that a favorable experience means a low rate, we cannot in all cases trust him to reveal the full extent of loss (where loss means the amount of compensation corresponding to the seriousness of the injury).

Conclusions.

It has been the intention of the writer to indicate in the foregoing pages that in all probability any system of compensation rates dependent upon the experience of the individual risk will be if universally applied so unpopular as to be virtually unworkable; that the chief genesis of the demand for consideration of individual experience in rating compensation risks lies in the hope for competitive advantage on the part of the carrier; and finally that although experience rating plans have sincere advocates among those who feel that such plans may constitute powerful influences toward accident prevention, there is reason to fear that experience rating in any form may harm rather than help the employee through giving the employer a financial interest in minimizing his workmen's claims.

If I mistake not, Dr. I. M. Rubinow in his illuminating work "Social Insurance" sets forth that in European countries the practice of permitting employers to carry their own risk has been found to work serious disadvantages to the employee. Workmen entitled thereto have failed to claim compensation through fear of dismissal, while employees with families or those whose age or physical condition makes them susceptible to injury have found it extremely difficult to obtain employment. If self-insurance tends to develop these abuses, experience rating would also be productive of them and in larger measure; for while permission to pay compensation directly is presumably granted only to the employer of financial responsibility, experience rating applies to many employers who are in no position financially to be more liberal with their employees than the exigencies of their situation may require.

We shall be making sufficient progress if for the present we devote our energies toward the development of methods whereby more equitable basic rates may be computed, and toward improving schedule rating systems and broadening the field of their application. Self-insurance should be conditioned not merely upon financial ability, but upon the spirit exhibited by the employer toward the grave obligations imposed upon him by the compensation law. Carriers issuing participating contracts should be required to calculate their dividends with respect to their entire experience or with respect to the experience of large groups, each group including many risks. The employer should not be encouraged in the false idea that his own experience is a proper criterion for an equitable rate.