



AMERICAN ACADEMY *of* ACTUARIES

March 12, 2004

The Honorable John Garamendi
California Department of Insurance
45 Fremont Street
22nd Floor
San Francisco, CA 94105

Dear Commissioner Garamendi:

The Committee on Property Liability Financial Reporting (COPLFR) is writing on behalf of the American Academy of Actuaries¹ (“Academy”) in response to the AB 227 Workers Compensation Actuarial Statement of Opinion Form promulgated by the California Department of Insurance. According to a November 25, 2003 rate filing notice, all California workers’ compensation insurers are required to make rate filings for policies that incept on or after January 1, 2004, and the Actuarial Statement of Opinion Form is required to be completed and enclosed with those rate filings.

In response to concerns expressed by many Academy members, we have reviewed the form and would like to draw your attention to some issues that we believe to pose significant, if not insurmountable, difficulties for actuaries required to complete the form.

In the second paragraph, the actuary is required to certify that the rates in the filing include a reasonable estimate of the insurer’s expected losses and expenses. In that same paragraph, the actuary is required to certify that the rates “shall be adequate” to cover the insurer’s losses and expenses. We believe that it is impossible for actuaries to provide the latter certification as required.

The work performed by actuaries to develop manual rates under any circumstance is based on estimates. These estimates are often subject to significant uncertainty due to continuous changes in the legal, economic and social environment and the randomness of workers compensation losses. In estimating manual rates, actuaries incorporate assumptions regarding a number of factors, including loss development, trend, and claim reporting patterns. In the case of California workers’ compensation, additional estimation is necessary because of the effects of legislative reforms such as AB 749, AB 227, and SB 228. These reforms were intended to affect benefit levels, medical utilization, vocational rehabilitation, and the presumption of the treating physician,

¹ The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

among other areas. They may significantly impact past and future claim costs. The amount of the impact of these reforms is subject to a wide variety of estimates, as evidenced by the estimates put forth by the California Workers' Compensation Insurance Rating Bureau (WCIRB), other industry sources, and the Insurance Department itself. The final effect of these changes will not be known for years.

Because the future experience of any insured may vary across extremely wide ranges, opinions regarding the eventual results of a group of risks must necessarily be statements of reasonableness or of estimated probabilities, rather than categorical assurances. Although an actuary may be able to produce estimates and draw conclusions that are reasonable based on the information available at the time, it is simply not possible to produce estimates that are sufficiently precise to enable anyone to certify that manual rates, beyond a doubt, "shall be adequate." Understanding the uncertainty underlying loss estimates generally, and the California workers compensation loss process in particular, we believe that a responsible actuary cannot, in good conscience, sign the required certification.

Furthermore, we believe that there are additional technical issues regarding the impact of commonly used premium modification plans that may cause ultimate premiums to be higher or lower than manual rates. Possible changes in the utilization of such rating plans provides another source of uncertainty, making the certification discussed above even more problematic.

The second paragraph of the form contains the sentence that "the rates shall be adequate to cover the insurer's losses and expenses, and are expected to result in a ratio of insurer net premiums to WCIRB pure premiums that is not less than the insurer's reasonable, average expense provision, stated as a factor." We assume that in this context, the form is referring to final collected premium; i.e., after all credits. The problem we see with this language is that such premium modification plans may cause the ratio of insurer premiums to WCIRB pure premiums to be different than the insurer's reasonable average expense provision, even in cases where it is the actuary's opinion that the rates are expected to be "adequate to cover the insurer's losses and expenses." The two parts of this sentence can be inconsistent with each other. For example, if an insurer writes a book of business heavily weighted towards experience modification credits, it could have reasonable rates that result in net premiums less than the WCIRB pure premiums loaded for expenses. Alternatively, if schedule credits are too large relative to the loss exposure, the insurer may have reasonable manual rates but inadequate ultimate net premium.

We suggest alternative language for this paragraph, such as:

"Pursuant to Title 10 of the California Code of Regulations §2509.32(j), I do hereby opine that the manual rates, i.e. rates before experience rating rates in the insurer's workers' compensation rate filing number _____ dated _____, have been determined in such a manner that they are projected to produce a reasonable estimate of the insurer's losses and expenses for the anticipated risks for _____ [define the period the insurer intends to use the filed rates]. Furthermore, pursuant to AB 1985 and California Insurance Code §11732, I do hereby opine that the rates are projected to result in a ratio of insurer net premiums to WCIRB pure premiums that is not less than the insurer's reasonable, average expense provision, stated as a factor, after consideration of experience rating. While the referenced rate filing reflects actuarial methods, factors, and assumptions I believe to be reasonable, actual experience may vary materially from my projected estimates of losses and expenses."

We hope these comments are helpful and would be happy to discuss them with you further. Please feel free to contact Greg Vass, Senior P/C Policy Analyst, at the Academy if we can be of further assistance.

Sincerely,

Andrea Sweeny, FCAS, FCA, MAAA, Chairperson
Committee on Property and Liability Financial Reporting
American Academy of Actuaries