



AMERICAN ACADEMY *of* ACTUARIES

August 28, 2008

Sarah McNair-Grove
Large Deductible Study Implementation Working Group
Workers' Compensation Task Force
National Association of Insurance Commissioners

Subject: First-Dollar Premium Equivalents for Large Deductible Policies

Dear Ms. McNair-Grove:

Thank you for the opportunity to provide a proposed model for the reporting of first-dollar premium equivalents for large deductible workers' compensation insurance policies to the Large Deductible Study Implementation Working Group (LDSIWG). The Workers' Compensation Subcommittee (WC Subcommittee) of the American Academy of Actuaries¹ is pleased to offer these comments pursuant to your request.

BACKGROUND:

“Large deductible” policies (under which the insured employer agrees to reimburse its carrier for losses up to an amount of \$100,000 or more on any claim(s)) are used to provide workers' compensation insurance to a substantial segment of the overall market. Regulators and other interested parties have difficulty assessing the exposure below the deductible amount because neither loss nor premium data are readily available. As these policies become more widely used, they attract regulatory attention and present a need for the actuarial community to quantify their impact on the marketplace.

Existing data reporting procedures for workers' compensation insurance generally include policy coverage data, unit statistical reports, and aggregate financial call data. Some jurisdictions also collect individual case reports, detailed claim information, and/or other special data calls. These existing data reporting procedures do not include or allow for a straightforward derivation of premium amounts that would have been applicable had all terms and conditions of the policy/policies being reported been in effect except for a large deductible coverage option. The reasons behind this circumstance, and the extent to which it applies, may vary from company to company. Having noted such variation within the industry, insurer pricing systems often combine the effects of large deductible coverage, premium discount, and/or schedule rating under the general heading of “deductible credits” when processing such policies. Further, the credits thus constructed

¹ The American Academy of Actuaries' mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

and applied may be stated and applied either before or after the effects of experience rating. These features of many carriers' workers' compensation pricing systems will produce material misstatements of "first-dollar equivalent" premiums if the combined credits are simply added back into net premiums reported on any policy/policies in an attempt to adjust premiums for the effect of large deductible coverage alone.

The LDSIWG has considered existing data and data reporting procedures at considerable length and has carefully considered possible modification of the Annual Statement as a means of gathering information about large deductible policies. The LDSIWG has concluded that a rigorous and technically correct remedy to or reformation of the existing system would be onerous and costly and has tabled the possibility of modifying the Annual Statement. Consistent with that conclusion, the LDSIWG has asked the WC Subcommittee to consider possible analytical approaches that could be used to approximate first-dollar premiums on large deductible policies relying on existing (or at least readily available) information. A preferred reporting construct could be used on an elective basis in states that may want to recognize and approximate the effects of large deductible policies on premiums for purposes of certain premium-based assessments (specifically not premium taxes) and/or may want to acquire additional information about the extent of large deductible business and its effect on the workers' compensation marketplace.

LIMITED NATURE OF THIS RESPONSE:

The request of the LDSIWG is presented in the context of current industry data reporting procedures and practices. The WC Subcommittee was asked to develop possible methods within those prevailing procedures and practices to approximate first-dollar premiums on large deductible policies. The WC Subcommittee was not asked to review or critique current data reporting procedures and practices, or to consider the merits of or possible approaches to substantive revision to those procedures and practices such that first-dollar premium equivalents for large deductible policies would be rigorously derived and separately stated as a matter of routine.

In considering this request, the WC Subcommittee understands and expects that instances in which any approach we suggest may be applied are limited in both number and scope. Accordingly, the response provided here is intended as a guideline for use in a small number of optional circumstances. It is not a recommendation that any state change current reporting requirements or methods for levying taxes and/or assessments on large deductible policies. The WC Subcommittee perceives the LDSIWG's interest as being the identification of an alternative approach that would be relatively simple to execute, acceptable to the industry, reasonably accurate as a basis for allocation of selected assessments, and indicative of the magnitude of the large deductible market for workers' compensation business.

THE WC SUBCOMMITTEE'S RESPONSE:

The WC Subcommittee has considered various approaches to this matter and has developed a consensus in support of using the following reporting items to develop a first-dollar earned premium equivalent for large deductible business:

1. Calendar Year Net Earned Premium for Large Deductible Policies
2. Calendar Year Case Incurred Losses Below the Applicable Deductible Level (Paid Losses During Year Plus Change in Case Outstanding Losses Below the Applicable Deductible) for Large Deductible Policies

The first element cited above is readily available to workers' compensation insurers. Similarly, the WC Subcommittee expects that paid losses below the applicable deductible level and changes in case outstanding losses below the applicable deductible level are generally obtainable from existing carrier systems and records.

It would be technically and theoretically correct to include a provision for the changes in Incurred But Not Reported (IBNR) losses below the applicable deductible in the construction of a first-dollar premium equivalent for large deductible policies. However, at present, insurers do not compute and/or maintain IBNR amounts for losses below deductible amounts by state and line of business. Accordingly, including this component of losses below the deductible would involve the collection of additional data by insurance companies. Further, depending upon the approaches adopted for this purpose and the characteristics of individual carrier business, the indicated IBNR calculations could produce volatile results and/or amounts that might appear to be unreliable. Given the difficulties in producing these estimates, and the potential anomalies associated with their computation and publication, the WC Subcommittee feels that it is appropriate to exclude this part of losses below the deductible threshold from the approximation of first-dollar premiums for large deductible business.

For large deductible business, the sum of net earned premiums and calendar-year case-incurred losses below the applicable deductible level will serve as a first-dollar premium equivalent. Adding the calendar year incurred losses below the deductible level for large deductible business to net earned premiums for all policies would produce an estimated aggregate first-dollar earned premium equivalent for all workers' compensation business. A proposed reporting format for this data accompanies this letter.

CONSIDERATIONS PERTAINING TO THE REQUEST AND RESPONSE:

Key observations about this approach arising from discussions of the WC Subcommittee are as follows:

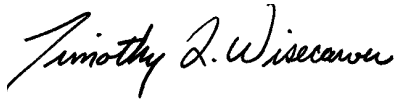
- “Large deductible” may mean different things to different audiences. For the sake of consistency for regulators and carriers, the WC Subcommittee recommends that prevailing definitions in use by the various workers’ compensation data collection organizations could be applied to this purpose, and if the definition thus applied, could be specifically articulated as part of the data reporting requests and instructions, if and when our proposed method is adopted.
- The combination of premium and losses envisioned above represents a reasonably efficient and substantially accurate first-dollar earned premium equivalent because it would include all of the following components:
 - the amount of losses subject to reimbursement by employers insured on a large-deductible basis,
 - amounts collected by the insurer for protection against losses above the deductible threshold, and
 - all expenses charged to insureds by carriers for large deductible policies.

Depending on definitions and practices in a given state, defense and cost containment expenses associated with loss amounts below the deductible threshold might be included as loss amounts or covered in the carrier’s expense charges, but, under either approach, the combination of premium and losses proposed would embrace all the appropriate components of a first-dollar premium equivalent.

- Our approach will most closely approximate calendar-year earned premium. We do not have a proposal in hand to address written premium, and we hope that this distinction will not unduly impair your consideration of the method presented here.
- While incurred losses for amounts below the deductible on large deductible business would not be prepared or presented in this form within the Annual Statement, carriers would presumably be able to document their tabulations or compilations of such amounts in support of their submissions using our proposal. It would be helpful to inform carriers in advance of this potential need, so that they may preserve and retain the pertinent reports and/or files.

The WC Subcommittee appreciates the opportunity to consider this matter and to share its comments with the LDSIWG. We would be delighted to discuss this response with you further at your convenience. If you have any questions regarding these comments, please feel free to contact Lauren Pachman, Casualty Policy Analyst, at pachman@actuary.org.

Sincerely,



Timothy Wisecarver, Chair
Workers' Compensation Subcommittee
American Academy of Actuaries

John Acquino
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Tom DeFalco
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* In light of her role as a representative of the NAIC's LDSIWG, Sarah McNair-Grove was not involved in the drafting of this document or the exhibit attached hereto.

**Sample Format for Proposed Data Reporting
First Dollar Earned Premium Equivalents for Large Deductible Business
(All Amounts to be Reported on a Direct Basis)**

Carrier Name _____

NAIC Number _____

State for Which Experience is Being Reported _____

Report for the Calendar Year Ending December 31, _____

- | | |
|---|----------|
| 1. Total Net Earned Premium for Workers Compensation Business
(Per Annual Statement, Statutory Page 14, Column (2) for State Shown Above) | \$ _____ |
| 2. Premium on Line (1) for Large Deductible Business | \$ _____ |
| 3. Calendar Year Case Incurred Losses Below the Applicable Deductible Retention
For Large Deductible Business (Paid Losses Plus Change in Case Outstanding,
Both for the Portion of Losses Below the Applicable Deductible Retention) | \$ _____ |
| 4. First-Dollar Earned Premium Equivalent for Large Deductible Business
Line (2) plus Line (3) | \$ _____ |
| 5. First-Dollar Earned Premium Equivalent for All Workers Compensation Business
Line (1) plus Line (3) | \$ _____ |