In the Matter of the Workers' Compensation Insurance Rate Application of the New York Compensation Insurance Rating Board	: : : : : :	**OPINION AND DECISION**

On June 29, 2007, an application for a 13.6% (a cost decrease equaling 16.2% net of the assessments) decrease in Workers' Compensation manual rates, effective October 1, 2007, was submitted to the Insurance Department (Department) by the New York Compensation Insurance Rating Board (NYCIRB).

The Department has reviewed NYCIRB's application and concludes that, after taking the reduced assessments into account, a cost decrease of 20.5% is approvable. NYCIRB is directed to refile in accordance with this Opinion & Decision.

DISCUSSION

NYCIRB serves as the private rate service organization for Workers' Compensation insurers in New York State and is licensed pursuant to Section 2313 of the Insurance Law. By statute, all Workers' Compensation insurers must report unit statistical and financial data to NYCIRB, a Department-licensed statistical agent. NYCIRB compiles and evaluates this data and proposes rate changes, which must have the Department's prior approval. Pursuant to Section 2305 of the Insurance Law, a public hearing must be held if the rate request is greater than 2%. Since NYCIRB filed for a rate decrease, no public hearing was held.

A. Experience

In the NYCIRB filing, the selected experience indication is the average of the Policy Year and Accident Year indications. The submission shows an indication for Policy Year 2005 of -5.2% and an indication for Accident Year 2006 of -4.6%. Both Policy Year and Accident Year methods rely on the use of loss development factors to project losses to their ultimate value. Such factors must be evaluated each year to assure that they are reasonable projections of past development patterns. At the present time, loss development factors are based on case-basis reserves. Case Basis reserves consist of paid and outstanding losses and do not include bulk or Incurred But Not Reported loss reserves. This method has been acceptable to the Department for several years, and appears to be generally reliable.

B. Underwriting Profit Provision and Return on Net Worth

For more than fifteen years, the Department has selected a 0% industry underwriting profit provision for Workers' Compensation rate making in New York State. The Department believes that the rate should not include an underwriting profit for a long-tailed insurance line such as Workers' Compensation. This does not mean, however, that insurers make no profit at all; rather, insurers' profit margin is to be derived from investment return instead of underwriting results. This profit target has worked well in enabling insurers to earn a reasonable return on net worth, although actual underwriting results can and do vary from 0%. Of course, in any given year, a particular insurer may earn both an underwriting profit and investment returns if they manage risk efficiently and invest surplus wisely

The tables below are taken from the National Association of Insurance Commissioners' Report on Profitability by Line and by State. The first table displays Loss Ratios and Return on Insurance Operations both as a percentage of Direct Earned Premiums and Return on Net Worth for New York for the latest ten years. The second table displays the same information on a countrywide basis. These tables indicate that Workers' Compensation insurers have earned a reasonable return over the last decade.

Determining an overall rate of return on net worth by line and by state is difficult, and no method currently in use considers all significant factors. Total return measurement is useful primarily for comparing results of one business segment (here, Workers' Compensation in New York) with other business segments (Workers' Compensation in other states, or other lines of business in New York). The figures are also useful for tracking changes in profitability over time. The profitability measurement figures, in themselves, do not have special significance and should not be judged to be "too high" or "too low". In particular, due to surplus and investment return allocation methods used by the NAIC, results can be distorted when reserves or other figures for New York's companies are significantly different from national averages.

For these reasons, the Department does not believe that a calculation of overall return on net worth is an entirely accurate measure of profitability. The Department does not believe that a calculation of overall return on net worth should be an integral part of the rate setting process. Better methods of measuring profitability, a longer time horizon, better statistical data, and more analysis from NYCIRB would be of assistance in monitoring this important aspect of the viability of the Workers' Compensation market.

NEW YORK – DIRECT
WORKERS' COMPENSATION

	(1) Losses Incurred Ratio	(2) % Return of Insurance Operations	(3) % Return on Net Worth
1996	76.8	4.4	6.5
1997	75.9	9.0	8.1
1998	58.7	19.9	11.4
1999	68.3	12.9	8.6
2000	73.2	17.2	11.0
2001	123.1	(27.8)	(8.1)
2002	74.0	9.9	8.1
2003	73.4	12.1	9.9
2004	74.2	10.6	8.4
2005	77.7	4.6	5.9

Notes:

Data taken from NAIC 2005 Profitability Report
Columns (1) through (3) are percentages of Direct Premiums Earned
Column (4) is a percentage of Net Worth as calculated in the NAIC profitability Report

Losses incurred do not include any loss adjustment expense
Data for 2001 includes WTC losses, although these are excluded from ratemaking data.

The State Insurance Fund is included in these figures. Its financial results may differ from those of the commercial carriers.

COUNTRYWIDE-DIRECT
WORKERS' COMPENSATION

	(1) Losses Incurred Ratio	(2) % Return on Insurance Operations	(3) % Return on Net Worth
1996	63.2	12.1	12.4
1997	61.9	14.3	12.8
1998	68.5	7.0	8.8
1999	76.6	(1.0)	4.5
2000	80.8	1.4	6.0
2001	85.9	(6.5)	0.2
2002	78.3	(1.3)	2.4
2003	73.3	3.9	6.9
2004	67.3	9.0	10.1
2005	64.8	8.8	9.6

Notes:

Data taken from NAIC 2005 Profitability Report

Columns (1) through (3) are percentages of Direct Premiums Earned

Column (4) is a percentage of Net Worth as calculated in the NAIC profitability Report

Losses incurred do not include any loss adjustment expense

Data for 2001 includes WTC losses, although these are excluded from ratemaking data

The State Insurance Fund is included in these figures. Its financial results may differ from those of the commercial carriers.

C. Loss and Wage Trend Factor

This year, as in years past, the trend factor is based on an analysis of exponential and linear regression lines of claim costs and frequencies. Wage data are analyzed separately, and the trends are shown separately for medical and indemnity claims. The indications for medical and indemnity are combined using a weighted average based on Policy Year 2005 adjusted ultimate losses valued as of December 31, 2006.

Loss trend data come from historical Schedule Z data (Unit Statistical Plan data) submitted to NYCIRB. The eight years of trend data in the current filing are 1997-2004. There are no available data for 2005 and 2006. Consequently, data in the required detail are not as recent as one might prefer.

Four trend lines are calculated: linear regressions based on five and eight years of data, and exponential regression based on five and eight years of data. Over the years the trend indication has generally been based on 5 year exponential trend lines. This year, each trend line was chosen based on its goodness of fit as measured by its R squared. For indemnity, the 8 year exponential trends were chosen; for medical, the 5 year linear trends were chosen.

NYCIRB calculates an Overall Trend Factor for 2007 of 1.055.

The wage factor is designed to account for rising payrolls, which exceed the corresponding increase in exposure to loss. The wage factor is based on published annual Department of Labor statistics. Because Workers' Compensation uses payroll as its exposure base, an increase in average wages will generally result in additional premium income.

It is worth comparing the indications, based solely on loss experience and before trend, of the past few rate submissions with the filed rate request.

Filing Year	Filed request	Policy Year Indication	Accident Year Indication
2007	-1.0% (approx)	(2005) -5.2%	(2006) -4.6%
2006	+7.5%	(2004) -4.0%	(2005) -3.3%
2005	+16.1%	(2003) +18.4%	(2004) +8.7%
2004	+29.3%	(2002) +27.6%	(2003) +33.2%

It appears that the requested rate increases may have somewhat overstated true rate need. At the same time, the rate actions taken by the Department during past rating cycles often fell short of rate need. Furthermore, for those years in which the submissions were completely rejected, the opportunity to conduct annual updates of class relativities was lost.

In this revision, both medical and indemnity claim cost trends continue upward, with medical claim cost trends worsening in the most recent years. The frequency numbers continue to show a decline in trend, although indemnity claim frequencies have risen in the most recent two years.

NYCIRB has modified its trend in an effort to take account of the 2007 reform legislation. It seems evident that these reforms will affect the future course of claim severity and frequency for Workers' Compensation. NYCIRB sought to address this by taking half of the combined wage/trend factor and projecting that into the future. We are not convinced that this is an appropriate method of accounting for this systemic change. Because benefit structures were so dramatically changed by the 2007 reform legislation, there is no basis for extrapolating past trends to future losses.

Furthermore, the 2006 Opinion and Decision noted that the trend calculation methodology had undergone a significant change from the year before, resulting in a much larger factor than the prior method would have produced. In particular, the Indemnity Claim Cost Trend Factor is sensitive to the method used to weight its underlying components. NYCIRB estimates a trend factor under the old method of 0.972 – 8.3 percentage points lower than their reported trend. We are troubled that the old and new methodologies produce such divergent results.

Given the sparseness of the underlying data, its age, and the major systemic changes, the Department is not persuaded that there is a statistically valid trend for this year's rate calculation.

D. Large Deductibles

The Department's position has been that business written on a large deductible basis represented a portion of a continuum of risk characteristics. Given this view, the Department believes that large deductible experience should be included in the General Rate Revision. This year, as in recent years, the Board's filing contains large deductible data.

E. Expenses

The expense provisions are based on private carrier data as reported on the Insurance Expense Exhibit and Statutory Page 14 of the Annual Statement. It should be noted that the decrease in expense provisions has an impact on overall rates of -1.3%.

In conjunction with the annual rate revision, NYCIRB reviews the elements of the minimum premium formula. In this year's revision, no changes are being proposed to the minimum premium formula. Consequently, the minimum premium formula in this revision will continue to include a $200 expense constant, the current rate multiplier of 110, and a maximum minimum premium of $875.

F. Assessments

Based on NYCIRB's rate filing, the New York Assessment Fee that is applied to an insured's standard premium would change from 18.6% to 14.9%. However, because of the lower rate and premium base directed by this Opinion and Decision, the Assessment Fee will constitute a slightly higher percentage of standard premium.

G. Catastrophes

In response to the September 11, 2001 attack, NYCIRB introduced a 3.0% catastrophe factor into the rate revision, effective October 1, 2002. This covered both foreign and domestic terrorism and natural disasters. In 2002, the federal government enacted the Terrorism Risk Insurance Act (TRIA). It provided a federal backstop to the companies' foreign terrorism exposure through December 31, 2005. The carrier retention under TRIA was 15% of earned premium.

In February of 2002, two-thirds of the Board's catastrophe charge was changed to a $.034 loading per $100 of payroll. This represented no change in the Board's original charge for foreign terrorism. The charge was in the form of a loading applied to payroll rather than a factor applied to the rate because the risk of incurring a loss due to terrorism appears to be independent of the inherent risk of a given employment.

NYCIRB did not file for any increase in this factor in the 2007 filing.

H. 2007 Workers Compensation Reform

On March 13, 2007, Governor Eliot Spitzer signed into law a series of landmark workers' compensation reforms intended to create a significantly less expensive system while increasing weekly benefits. Accompanying this legislation was a letter from the Governor to the Superintendent of Insurance, the Commissioner of Labor and the Chair of the Workers' Compensation Board (the Board) requesting several supplemental reforms and reports. NYCIRB has attempted to estimate the impact of the reform package on the rates by evaluating the cumulative effect of each major initiative.

Benefit Changes

The new law increases the maximum weekly benefit from $400 to $500 for much of the rating period and caps the benefit duration for Permanent Partial Disability (PPD) awards according to a schedule based on level of disability. NYCIRB estimates that this benefit increase will lead to a modest 6% increase in the rate indication, while the duration caps will lead to a 28% decrease.

NYCIRB estimates the additional costs associated with the increase in the maximum benefits by evaluating the impact across a national distribution of wages and payrolls. The distribution is centered according to New York's statewide average weekly wage as reported by the New York State Department of Labor. Insofar as the wage or payroll distribution in New York State differs from the national distributions, the resulting estimates are likely to be imprecise. Furthermore, the impact of the benefit increase depends on the distribution of disability rating for PPD claims. NYCIRB simply applies the average disability to the average weekly wage. This also tends to reduce the precision of the estimates.

NYCIRB's savings estimates due to the duration caps also rely on the use of coarse distributions. NYCIRB calculates the cost reduction by evaluating the reduction across the distribution of disability furnished by the Board. This approach relies on the assumption that for each disability level the distribution of age, wages and expected duration of lifetime disability payments are identical. NYCIRB provides little support for this assumption in its filing.

A better approach for scoring the impact of the benefit increase and the duration caps would rely on micro-data from the population of claims. Indeed, a data set consisting of historic claims data on disability rating, age and pre-disability weekly wage would be adequate to perform the calculation with significantly greater precision. Thus, the Department has concerns with NYCIRB's methodology.

Medical Savings

The new law and the Governor's accompanying letter provide for several cost-saving reforms related to the medical treatment of injured workers. Under the new law, employers and carriers can establish mandatory networks for pharmacy and diagnostic testing. In addition, the Board will establish fee schedules for pharmacy, diagnostic testing and Durable Medical Equipment (DME). The Governor's letter directs the Department to provide the Board with a set of medical treatment guidelines to limit unproven, unnecessary, or inappropriate treatment. The combined effect of the networks, fee schedules and medical treatment guidelines will result in significant system savings and improved system quality.

NYCIRB estimates the networks and fee schedules will lower the rate indication by 2.4%. NYCIRB's savings estimate is based largely on anecdotal opinions of actuarial committee members about the discounts that carriers currently receive from the use of voluntary pharmacy, DME, and diagnostic testing networks. The Department does not consider this a reliable approach. It would be straightforward to use a sample of actual reimbursement transactions and directly calculate the savings due to increased network participation or the use of the fee schedules.

NYCIRB has chosen not to make an actuarial estimate of the savings that will result from the medical treatment guidelines. The Department believes that these savings will be significant. The State of California adopted treatment guidelines in 2004 and it is estimated that these guidelines have produced medical savings of over 45%. New York is unlikely to achieve savings of this magnitude for a variety of reasons, but should nonetheless see a substantial reduction in medical costs once medical treatment guidelines are in place.

The Closing of the Special Disability Fund

The Special Disability Fund (SDF) was established to protect employers who hired injured World War II veterans. The SDF reimburses carriers or employers for benefits paid to injured workers whose work injuries were compounded by pre-existing injuries or disabilities. In recent years, the number of claims established for reimbursement has grown significantly, increasing the industry-wide premium assessment that funds the SDF. Since the SDF reimburses the carrier for the losses, there is little incentive for reimbursed carriers to settle or otherwise reduce their exposure to these claims. The reform legislation eliminates these inefficiencies by closing the SDF to any injuries occurring after July 1, 2007. The SDF will continue to reimburse carriers for existing liabilities.

The closing of the SDF means that the losses for injuries that would have been eligible for reimbursement by the SDF will now become part of the carriers' loss experience. Adding these additional claims to the rate calculation will offset some of the rate cuts that accrue from the other reforms. NYCIRB estimates the cost of claims that would have been eligible for SDF reimbursement by taking the three-year average annual reimbursement to private carriers and the State Fund and reducing this amount by 15%. This reduction takes into account the carriers' increased incentive to manage these risks after the SDF closes, but appears to have been chosen arbitrarily. The closing of the SDF raises NYCIRB's rate indication by approximately 13%.

The Department believes that NYCIRB overestimates the rate impact of the SDF's closing for two primary reasons. First, current reimbursement levels reflect claims received over a number of past years, but do not necessarily reflect the frequency or severity of claims in the two future years covered by the rate revision. Indeed, claim frequency in New York State has been declining consistently for many years. Second, NYCIRB understates the likely savings that will result from increased risk management. In particular, SDF-reimbursed claims almost never settle under Section 32 of the Workers' Compensation Law, but non-SDF claims settle quite frequently. Settlements generate significant reductions in claim costs. The Department believes that NYCIRB has significantly understated the mitigating effect of improved risk management on the rate impact of the SDF's closing.

Overall Impact of the 2007 Reforms

NYCIRB estimates that the reform legislation will reduce losses by 17.1%. However, NYCIRB translates this into a rate reduction of just 13.3%. This adjustment is based on NYCIRB's distinction between fixed and variable components of the expense provision. NYCIRB argues that the loss reduction will only lead to a reduction in variable costs while fixed costs will remain unchanged.

The Department disagrees with this approach. NYCIRB's treatment of expenses after the reform-driven loss reduction is inconsistent with the way NYCIRB treats expenses when there are other changes to losses. In particular, NYCIRB regularly estimates significant increases to losses resulting from trend factors, but does not appear to have ever discounted these trend factors to account for the fixed cost component of expenses. Finally, the Department does not believe that the fixed versus variable cost distinction is economically valid for claim losses that develop over long time horizons.

I. Findings

Based on the foregoing, the Department's finding, after taking the reduced assessments into account, is that a cost reduction of 20.5% is approvable for policies written in the year beginning October 1, 2007.

DECISION

Based on the review of the filing conducted by the Department, the New York Compensation Insurance Rating Board is hereby ORDERED to refile in accordance with the Department's findings.

DATED: July 15, 2007
New York, New York

Eric Dinallo
Superintendent of Insurance