Order R04-10

APPROVAL WITH MODIFICATIONS OF 2005 WORKERS' COMPENSATION LOSS COST FILING AND ASSIGNED RISK RATE FILING

BACKGROUND:

On August 18, 2004, the Alaska Division of Insurance (division) received the 2005 Alaska Workers Compensation Filing For Voluntary Loss Costs and Assigned Risk Rates from the National Council on Compensation Insurance, Inc. (NCCI). This filing proposed an overall 9.5% increase in voluntary loss costs and a 12.5% overall increase in assigned risk rates from the current approved levels.

On August 19, 2004, the director issued Notice of Public Hearing H 04-02 notifying interested parties that in accordance with Alaska Statute 21.39.043 a hearing would be held on September 9, 2004. The purpose of the hearing was to allow interested parties to provide testimony or evidence as to whether the filing's prospective loss costs meet the requirements of AS 21.39. Interested parties were also invited to include a recommendation for approval, disapproval, or modification of the filing

Prior to the hearing, both the division and interested parties sent interrogatories to NCCI requesting additional supporting information. In addition, one interested party, Alaska National Insurance Company (ANIC), requested that NCCI make modifications to the filing. ANIC also discussed the requested modifications at the hearing. Subsequent to the hearing, NCCI and ANIC provided additional written testimony. The division also asked for additional supporting information.

DISCUSSION OF FILING METHODOLOGY

NCCI included several changes in methodology in the 2005 prospective loss cost and assigned risk rate filing. These changes included the addition of a large loss procedure, use of paid losses and case reserve to select loss development factors, exclusion of maritime premium and loss data in the overall indication, a change in methodology for computing the USL&H percentage, and inclusion of excess of loss reinsurance and an underwriting contingency provision for the Alaska Assigned Risk pool.

1. According to NCCI, the large loss procedure is intended to smooth the impact of individual large claims on the overall statewide indication as well as provide for more appropriate funding of large losses.

2. NCCI also proposed using paid losses and case reserves (paid+case) as the basis for calculating the overall indication. Historically, the Alaska loss cost and assigned risk filings have used only paid losses to determine the overall indication. Over the past few years, paid loss development factors have been increasing and may no longer be an accurate reflection of changes in claim costs or settlement patterns. The inclusion of case reserves recognizes an insurer's changing estimates of claim costs better than does the use of paid losses alone. However, including case reserves has the disadvantage that fluctuating reserve adequacy can produce misleading indications.

3. With the change to the use of paid+case data, NCCI also needed to select the number of years of data to average in the selection of the loss development factors. Historically, NCCI used the most recent three years of data, with the exception of the 2004 filing in which the most recent two years of data were used. With the 2005 filing, NCCI proposes to use the most recent five years of data, excluding the highest and lowest factors. NCCI bases this selection on the fact that the five year, excluding the highest and lowest factors, (5-year xhilo) smoothes out volatility as well as differences in individual insurer reserving practices.

4. In the 2004 filing, NCCI implemented a new methodology related to the use of maritime data in calculating the overall indication. Since maritime classifications have a different benefit structure than the industrial classifications, the use of maritime experience can result in inaccurate loss costs for the industrial classes. In 2004, NCCI continued to use the maritime premium information, but included an on-leveling procedure to bring the maritime premiums to current levels. In the 2005 filing, NCCI refined the method used and excluded the maritime experience altogether.

5. NCCI also proposes an increase in the United States Longshore & Harbor Workers Act (USL&H) percentage from 25% to 56% of the non-F classification loss cost. This proposed increase is the result of a change in methodology in which the USL&H percentage is based on the difference between federal benefits and Alaska benefits.

6. NCCI proposes two changes in the expense components for the assigned risk rates. The first change is the inclusion of a provision for the purchase of excess of loss reinsurance for the Alaska Assigned Risk Pool. The second change is the addition of an underwriting contingency provision. The rationale for the underwriting contingency provision is that insurers are receiving less investment income due to low interest rates and to provide protection against the additional risk in the assigned risk market.

INTERESTED PARTIES' REQUESTED MODIFICATIONS

Alaska National Insurance Company requested that NCCI incorporate three modifications into the 2005 loss cost filing. The requested modifications were 1) use the most recent three-year average to select the loss development factors, 2) increase the indemnity trend from 0.99 to 0.993 and increase the medical trend from 1.04 to 1.05, and 3) modify the unallocated loss adjustment expense (ULAE) provision to be a weighted average of the countrywide ULAE factors, and any approved deviations, for the top three insurer groups in Alaska.

1. ANIC believes that the selection of loss development factors based on the most recent five years, exclusive of the highest and lowest factor, results in loss costs that are inadequate because the overall indication using the 5-year xhilo method is lower than the indications if either a 2-year, 3-year or 5-year average are used.

2. ANIC recommended a change in the trend factors selected by NCCI since the implied frequency trend of –4.0% in the selected medical and indemnity loss ratio trends would be more likely to underestimate than overestimate the loss costs.

3. The provision for ULAE is based on countrywide data as no data is available that distributes ULAE on a state-by-state basis. ANIC requested that more Alaska specific data be used to determine the appropriate ULAE load. In particular, ANIC argued that since they wrote 42.6% of the premium in Alaska, including policies written as a servicing carrier for the assigned risk pool, their higher ULAE costs provide a credible indication that ULAE in Alaska is higher than the countrywide ULAE.

NCCI REBUTTAL

NCCI elected not to include the ANIC's proposed modifications for the following reasons.

1. NCCI argued that the 5-year xhilo method is appropriate when all methods are considered in context. The change in methodology from paid to paid+case, the evaluation of indications based on many different assumptions including accident year and policy year analyses including various loss development factor selections and data volatility make the 5-year xhilo selection the preferred method to use.

2. NCCI indicated that they look at frequency and severity trends together, not independently. NCCI noted that the accident year and policy year trend lines track each other closely and that the selected trend is very close to the average of the accident year and policy year exponential loss ratio trends.

3. NCCI's analysis of ULAE using data provided to NCCI by insurers indicates that there is little difference between ULAE ratios for Alaska insurers compared to the countrywide ratios. In addition, the nature of ULAE is that it is a countrywide number and cannot reliably be allocated to individual states.

FINDINGS

After fully reviewing and considering the supporting documentation and testimony, both written and oral, the director finds:

1. The use of a large loss procedure as proposed by NCCI is an acceptable method to account for the impact of individual large claims.

2. The change in methodology from paid to paid+case is an acceptable change in order to reflect changes in claims settlement costs and patterns.

3. The use of the 5-year xhilo method to select loss development factors is acceptable. While the resulting indication is one factor that should be considered, NCCI has provided adequate support to demonstrate that multiple considerations went into the selection of the loss development factors. The considerations related to case reserve fluctuations, the change in methodology from paid to paid+case and stability are all valid issues to be accounted for when selecting loss development factors.

4. The total exclusion of maritime experience is an acceptable change in methodology.

5. The proposed change in USL&H factor has not been adequately supported. No data was provided that shows actual experience for the non-F classification USL&H exposure. While the director recognizes that Alaska data is limited and not always credible, the only actual experience provided related to a comparison of F class experience with comparable state act class experience.

NCCI first proposed the new USL&H methodology in the 2004 filing. Documentation provided by NCCI to support the proposed change in USL&H factor for 2004 included a credibility weighting of the factor based on the new methodology with a weighted average ratio of F-class pure premium to state act class pure premium. NCCI did not include the credibility weighting procedure for the 2005 filing due to the volatile nature of the data and the small amount of credibility (less than 10%) of the Alaska data. However, were the same credibility procedure to be applied to the 2005 filing, the credibility weighted indication would be approximately 1.90 versus the 2.49 calculated for the 2004 filing. Even without the credibility calculation, there is substantial difference between the factor determined last year, 2.61, and the factor calculated in this filing, 2.01.

Due to the volatility of the methodology and the lack of actual experience for the non-F class USL&H exposure, adequate support has not been provided to justify a 25% increase in the USL&H factor. While a 25% increase in the USL&H factor will not be approved, the evidence would support some increase in the USL&H percentage. The director will approve an increase in the USL&H percentage from 25% to 30%.

6. The excess of loss reinsurance provision is acceptable. This concept was proposed at the October 2003 Alaska Workers Compensation Review and Advisory Committee (ARAC) meeting. Due to the increasing size of the assigned risk pool and the resulting potential for a catastrophic loss to increase the assigned risk burden on voluntary insurers, at the January 2004 meeting ARAC recommended that NCCI obtain bids and include the cost of excess of loss reinsurance in the 2005 assigned risk rate filing. At this time, the director agrees with the assessment of the ARAC that a provision for reinsurance may be one factor that may enhance the workers' compensation insurance environment for insurers writing voluntary business in Alaska.

7. The proposed underwriting contingency fee is not acceptable. The proposed underwriting contingency fee is based on an internal rate of return analysis similar to the profit and contingency provision that was filed and disapproved in the 2004 assigned risk rate filing. Internal rate of return models are customarily used to determine underwriting profit provisions not contingency provisions.

   NCCI has argued that the contingency provision is to "support an overall reasonable return on investment." The assigned risk pool is a market for employers that are otherwise unable to obtain workers' compensation coverage in the voluntary market. The assigned risk pool does not exist in order to make a profit or receive a return on its investment. There is a difference between a provision for contingencies and a profit provision that the 2005 NCCI filing does not take into consideration. The proposed 2005 contingency fee is the same amount, 2.5%, as the profit and contingency fee proposed in the 2004 filing. In addition, prior to 1998, when NCCI filed voluntary rates in Alaska, the expense provision included a 2.5% profit and contingency provision. The proposed contingency fee is excessive and has not been supported by appropriate documentation or analysis.

8. The loss ratio trends selected by NCCI are within a reasonable range of potential trends. However, because the accident year data was determined to be too immature to use in calculating the overall indication, it is appropriate to give less weight to the accident year exponential trend than to the policy year exponential trend.

9. The director finds that NCCI has provided adequate support for the proposed ULAE provision.

ORDER

For the reasons set forth above, the director orders:

A. that the overall indication be revised to 12.0% for both the voluntary loss costs and the assigned risk rates based on the following modifications to the filing:

   1. The indemnity loss ratio trend should be increased from 0.99 to 0.993.

   2. The medical loss ratio trend should be increased from 1.04 to 1.047.

   3. The underwriting contingency fee should be removed from the assigned risk rates resulting in no change to the expense provision.

To obtain the revised overall rate change, the industrial class loss costs will each increase by a uniform percentage.

For the coal mine classes, the traumatic portion of the loss cost will also increase by the same uniform percentage as the industrial classes. The disease portion of the loss cost will remain as originally filed.

For the F-classes, a revised overall rate change incorporating the new trends will be calculated. Each individual F-class proposed loss cost will be increased by the same uniform percentage to achieve the revised overall F-class indication.

B. The USL&H percentage should be revised to 30%.

Dated: November 12, 2004

Linda S. Hall
Director