



AMERICAN ACADEMY *of* ACTUARIES

July 7, 2006

Ms. Sarah McNair-Grove, Chair
Workers' Compensation Large Deductible Subgroup of the Casualty Actuarial (C) Task Force
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604

Re: Workers' Compensation Large Deductible Study

Dear Ms. McNair-Grove:

The Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries¹ (the Academy) was asked to respond to questions posed by the Workers' Compensation Large Deductible Subgroup of the Casualty Actuarial (C) Task Force (CATF) in the attached letter dated January 27, 2006, concerning recommendations #14 and #15 of the Workers' Compensation (C) Task Force's *Workers' Compensation Large Deductible Study* ("Large Deductible Study"). The Large Deductible Study referred several recommendations to the CATF for review; these are discussed below. The CATF, in its letter to COPLFR, has requested assistance from COPLFR with regard to reviewing the recommendations contained in the study.

COPLFR appreciates the opportunity to provide input into this project. Our responses to CATF's request were developed based on our committee's review of the Large Deductible Study, as well as internal discussions, discussions with several regulators, and discussions with Alan Wickman, the primary author of the Large Deductible Study.

COPLFR's responses should be considered only a starting point in the discourse on this complex topic. In addition, COPLFR understands that the Academy's Workers' Compensation Subcommittee (WC Subcommittee) has expressed interest in contributing to the discussion as well. We encourage the CATF to also obtain the WC Subcommittee's views on the points raised in this letter. Furthermore, COPLFR suggests an in-depth discussion with accounting experts, as well as further research on and analysis of insurers' data resources, would be very helpful to determining the best path forward on the matters raised by the CATF. If the CATF wishes to form a larger subgroup containing members of CATF, COPLFR, and the WC Subcommittee, COPLFR would be happy to participate.

¹ The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

For the two recommendations on which the CATF sought our views COPLFR has provided its summary comments as well as responses to some of the specific questions asked by CATF. There are other questions that we have not specifically answered because our preliminary review indicates that such answers would be lacking the full consideration they deserve without significant research and analysis, particularly regarding carriers' practices and capabilities, or in-depth discussions with accounting experts. We have also identified several matters that we believe should be considered in reaching decisions regarding the appropriate level of disclosure and other matters.

Recommendation #14

“Annual Statement reporting should be amended to show workers’ compensation losses under the deductible threshold on a state-by-state basis.”

It is COPLFR’s understanding that the primary goal of Recommendation #14 was to develop a consistent procedure for assessing the various state-operated funds that support the workers’ compensation system. Another goal was for regulators to be provided a more all-encompassing view of the workers’ compensation marketplace in their respective states.

With this in mind, COPLFR has several general comments:

- Premium and/or loss-based assessments for workers’ compensation currently exist in some states. The bases of such assessments, which can vary by state, are either gross (i.e. first-dollar basis) or net of deductibles. If the Annual Statement included all applicable bases for assessments, premium or loss-based, gross or net of deductibles, then this may eliminate the “one-off” reporting that is necessary for reporting the deductible assessment bases that exist today. However, this would be difficult for companies, as there are currently many bases used for assessment purposes; e.g., gross and/or net of deductibles, state-specific information, data under the U. S. Longshore and Harbor Workers’ Compensation Act, etc., and it could result in a significant increase in the amount of information provided in the Annual Statement.
- We understand that some regulators would like the Annual Statement data to include paid losses, a measure of exposure (i.e., premium equivalents), and total incurred losses [i.e., including incurred-but-not-reported (IBNR) losses]. The regulators we spoke to acknowledge that total incurred losses are unlikely to be used for assessment purposes. This recommendation may present issues for those carriers who do not maintain sufficiently detailed data within Annual Statement reporting systems that provide such data.
- With regard to paid losses within the deductible, we expect that most companies retain such amounts, at least for statistical reporting purposes.

However, with respect to loss reserves and calendar year incurred losses, there is considerable variation in practice among carriers regarding the level of detail maintained and their ability to report amounts by state in the Annual Statement using their current systems. The actuary currently provides disclosure in the aggregate of reserve credit taken for losses within the deductible. Some carriers may be challenged to report data by state because their systems and processes would need to be changed or enhanced for such reporting. Also, it is possible that some deductible policies cover insurers operating in multiple states for some, but not necessarily all, loss adjustment expenses to be reimbursable as part of the deductible.

- Finally, we see some issues related to selecting an appropriate base for presenting first-dollar premium equivalents in the Annual Statement. One issue is that a significant volume of such premium equivalents would come from large deductible policies sold to very large entities. If such entities were insured without a deductible, many would most likely select some form of retrospectively rated or loss rated policy. Consequently, the premium equivalents would be more directly related to the loss rating or estimated ultimate retro premium. Standard premiums for workers' compensation would reflect class loss costs (or rates), adjusted for the applicable experience rating modification factor. Such standard premiums can be materially different than a loss-based premium equivalent for large individual risks.

While regulators may be interested in obtaining first dollar premium equivalents reported in order to understand the true size of their state's workers' compensation marketplace, such reports may be misleading. The use of deductible policies ranges from large multi-state organizations with very substantial annual losses to medium-sized businesses with only modest size deductibles. In fact, the very large organizations use large deductible policies as an alternative to self-insurance. Consequently, it is difficult to design a relatively simple premium equivalent formula that would approximate the commercial market premium. While some type of exposure-based premium equivalent may be possible, such an approach would probably not accurately represent a market premium for most large policyholders.

CATF Question 1:

1. *Does an exhibit showing paid, incurred and unpaid deductible losses provide adequate information on losses under the deductible threshold? Should total amounts recovered under the deductible be shown?*

It is difficult to comment on the suggested changes to Annual Statement reporting because our understanding of the specific purpose of each one is not clear – in other words, we would like to better understand how such information is expected to be used. We have attempted to answer this question without a full understanding of the specific intended use. Therefore, we do not have a view as to (a) whether information described above is adequate for a regulator's purpose(s), or (b) whether total amounts recovered under the deductible should be shown.

If the information is intended for carriers to report the assessment basis for workers' compensation deductibles in the Annual Statement, then the information provided in the Annual Statement for losses within the deductible may differ by state. Such differences might require segregating losses from defense and cost containment (DCC) expenses, showing indemnity and medical expenses separately, etc. A survey of each state to determine such assessment bases would be needed to ensure that appropriate information was included.

Regarding a company's exposure from deductible contracts, having paid, incurred, and unpaid amounts presented, for example, in similar detail as that provided for currently in the State Pages may provide value to a regulator. However, the incurred and unpaid amounts within the deductible would be effective only as a general guide of exposure, due to differences surrounding how reserves are established and how allocations by state are determined.

From a technical actuarial viewpoint, it can be difficult to analyze and compare current Annual Statement data, which is net of deductibles, particularly when the extent of use of deductibles can vary substantially. However, we note that carriers have established their internal processes, systems, and

controls to meet the current reporting requirements. Consequently, a change to reporting gross of deductibles separately from deductible recoveries poses a number of practical issues, which can vary greatly among carriers.

We see the CATF question of whether certain deductible loss data would be adequate as dependent upon the need for and uses of such data. Without considering cost or other potential difficulties involved in gathering or reporting such data, actuaries will generally prefer more consistent, homogeneous paid and case incurred data, split between gross and net of deductible recoveries, and the amounts of deductible recoveries, in the familiar Schedule P format. While this may provide a reasonable basis for reporting, key considerations include:

- The mix of deductible amounts between carriers and between policy years for the same carrier;
- State differences in the use of deductibles versus retros and other plans. Such differences can complicate countrywide development patterns, particularly at the state level;
- Splitting gross versus net of deductibles can be complicated by reinsurance and subrogation recoveries;
- Premium equivalents are not normally part of a carrier's financial accounting systems but rather are normally part of separate statistical reporting systems.

CATF Questions 2 and 3:

2. *What would be the most cost effective way for the total exposure on deductible policies to be expressed in the Annual Statement? Should the total exposure be calculated using the state's rates or loss costs applied to the total policy payroll? Are there other appropriate methods? If so, what are they?*
3. *Do the means by which premiums for deductible policies are "grossed-up" depend upon the purpose for which the gross premiums will be used? Some of these purposes might be market analysis and how workers' compensation losses change over time, or special assessments such as second injury funds and guaranty association assessments.*

With respect to questions #2 and #3, in keeping with the limited focus of assessments, optimal solutions will make use of fields that are currently in use in statistical reporting. Therefore, we encourage disclosure of premium equivalents that use the deductible credit that exists today in statistical reporting. However, even this solution will result in inconsistencies of premium across types of policies. As an example, the deductible credits are likely reported before the impact of premium discounts, which means that the "first-dollar" premium reported for large deductible policyholders would be inconsistent with the premium for policyholders written on a first-dollar policy. Likewise, a similar account written on a first-dollar basis would likely be written using a retrospectively rated policy, and that premium base would include the impact of retrospectively calculated credits or debits, none of which are contemplated in the deductible credit. Please see "Other Comments on Assessments" below for our suggested first step in crafting new reporting requirements.

CATF Question 4:

4. *What data is already collected by workers' compensation rating organizations that should be considered in developing the Annual Statement report? If a data reporting format for losses under the deductible threshold already exists, can it be used as the basis for Annual Statement reporting, including cross-checks?*

COPLFR understands that these same questions have been posed to the National Council on Compensation Insurance (NCCI); we presume that the NCCI is better equipped to respond to question 4 than is COPLFR.

Other Comments on Assessments

As a first step, COPLFR recommends to the CATF that an effort be made to identify, on a state by state basis, current reporting structures for which a state receives first-dollar premium and/or loss information, including the timing of the reporting and the purpose, source, and detail of the data. This information should be useful in crafting any new reporting requirements. We expect this information may prove useful, but it is likely to vary considerably from state to state. It may take some time to determine common practices and best practices. (Examples include written premium vs. earned premium, policy period vs. calendar period, and all paid losses vs. indemnity paid losses only.)

There are several other considerations about the proposed Annual Statement reporting that COPLFR would like to bring to your attention:

- 1) First-dollar amounts are not currently included in insurers' financial reporting; there are likely no existing "control totals" for these amounts.
- 2) In many instances, both loss and DCC satisfy the deductible, according to the large deductible policy provisions. In those cases, the request for "loss" data should be interpreted to mean "loss plus DCC."
- 3) The definition of "large" for any new reporting will need to be clear. In some cases, the term "large deductible" is defined by state law.
- 4) Please confirm that this new reporting would be aimed solely at Workers' Compensation and would not include large deductible business for other lines, since those were not included in the original study.
- 5) Please confirm that the requirement for losses underneath the deductible does not include small or intermediate (i.e., not "large") deductibles, since, in some insurer systems, small deductibles may be not readily identifiable.
- 6) A new report could be similar in format to Special Page 14, in which premium and loss data appears by state. Column headings will have to be very carefully designed.
- 7) An insurance company client may have "bought back" the large deductible from its insured at the expiration of the policy, and the data may be affected as a result. In order to clarify this, perhaps a new question might be asked regarding deductible buybacks as part of the General Interrogatories or Notes to Financial Statements.

Recommendation #15

"Further study should be done with regard to apparent disconnects in accounting requirements for loss recoveries under large deductible programs."

COPLFR understands that the Large Deductible Report identified issues regarding the reporting of deductible amounts. Such issues include the manner in which the risk for potentially uncollectible amounts is considered in the financial reporting process and potential mismatches between setting loss reserves for past due deductible reimbursements and then recognizing such amounts as credit losses, rather than as paid losses through Schedule P, when such amounts are written off.

The CATF asked numerous questions on this recommendation. COPLFR has not answered each question specifically, since we have not completed or reviewed the extensive analysis and research necessary to reach a meaningful conclusion on certain points. In addition, we believe questions #9 and #10 are more appropriately addressed with discussion and input from accounting professionals, and, therefore, we did not address these questions in our response.

CATF Questions 5 and 6:

5. *How should losses under the deductible threshold be accounted for to more accurately reflect the risk to the insurer that some of these losses will become the responsibility of the insurer? Should all collateralized losses be excluded from loss reserves? Is there any exposure to the insurer from collateralized losses that would require some level of reserves? For losses that are not collateralized and not past due, does 10% of the non-collateralized loss provide an adequate loss reserve? If not, how should the loss reserve for non-collateralized deductibles that are not overdue be determined? Should 100% of a past due loss under the deductible threshold that is not collateralized be required to be set up as a loss reserve?*
6. *Should the reserves for losses under the deductible threshold be booked recognizing the insurer's reasonable expectation that the insurer may incur unreimbursed losses? If so, does there need to be disclosure of how the expected unreimbursed losses were determined?*

With regard to questions 5 and 6, COPLFR believes, in principle, that statutory reporting should consider, as appropriate, expected unreimbursed amounts on deductible policies. We believe that techniques normally used by actuaries to evaluate unrecoverable reinsurance and other credit losses could be adapted and applied to develop expected unreimbursed losses. The CATF may wish to consider the inclusion of reserves for uncollectible amounts within the scope of the Statement of Actuarial Opinion. If included in the opinion, consideration of such amounts could be included in the actuaries' analysis as provisions for uncollectible reinsurance are included, and reporting of specific methods or other requirements might not be necessary. This treatment would allow insurers to consider collateral as it applies to their unique situations.

For some companies, this suggestion is consistent with existing practice. For other companies, the consideration of unreimbursed losses may be more of an accounting function than an actuarial function.

COPLFR believes that expected loss approaches have an advantage over statutory penalties, such as 10% of the non-collateralized loss or 100% of past due, uncollateralized amounts. More importantly, we do not have sufficient information to form a view as to whether the specific provisions described in the questions above would be adequate or appropriate for statutory reporting.

CATF Questions 7 and 8:

7. *How should losses that are reimbursed flow through the Annual Statement? How should losses under the deductible threshold that are not reimbursed by the insured flow through the Annual Statement to recognize that these losses can result in claim payments from the insurer?*

8. *Should loss amounts under the deductible threshold that are recovered by the insurer be disclosed in the Annual Statement? If so, should Schedule P be amended or should there be a separate exhibit?*

Regarding questions 7 and 8, one of the major concerns of the authors of the Large Deductible Study is that uncollected and/or uncollectible losses should flow through Schedule P. Currently, COPLFR understands that there is a concern that the practice of accounting for potential unreimbursed losses is inconsistent. We refer to paragraphs 35 and 36 within SSAP #65. Paragraph 35 says “No reserve credit shall be permitted for any claim in which any amount due from the insured has been determined to be uncollectible.” Paragraph 36 says “Reimbursement of the deductible shall be accrued and recorded as a reduction of paid losses simultaneously with the recording of the paid loss by the reporting entity.” We do not believe these two paragraphs are completely clear, and we believe that practice across the industry is not consistent in this area.

COPLFR would therefore suggest a revision or an interpretation of SSAP #65’s wording so the statutory accounting intent is more explicit. We believe that one such interpretation could read as follows:

“In all cases, loss and DCC as reported in the statutory Annual Statement should include paid amounts and a provision for unpaid loss and DCC under deductible policies originally due from the policyholder that the insurer has deemed as uncollectible.”

We believe this suggested wording for SSAP #65 would mean that a provision for expected unreimbursed losses would be calculated and would flow through Schedule P. This would be consistent with the treatment of losses due to unrecoverable reinsurance.

However, this suggestion has disadvantages as well. Collections from policyholders on large deductible policies often include amounts from multiple accident years and even multiple lines of business. Therefore, reporting unreimbursed amounts in detail for Annual Statement purposes may require allocations. In addition, uncollectible premiums, particularly amounts related to high deductible and other retrospectively rated contracts, currently do not flow through the premium accounts, so the suggested language above could lead to a mismatch in the treatment of amounts that are uncollectible from a policyholder. Furthermore, there are more detailed accounting questions to be resolved, including how estimated unreimbursed losses move from a “reserve” category to a “paid” category. COPLFR believes CATF would be well served by reaching out to other constituencies in formulating responses to these questions.

While COPLFR does not believe that these issues are insurmountable, we believe all relevant issues such as these should be identified and considered before making changes to statutory accounting or Annual Statement reporting. We also believe such changes should strive for logical consistency and transparency in the financial reporting process.

Finally, we do not have a view as to how a regulator would consider disclosure of loss amounts under the deductible threshold that are recovered by the insurer.

July 7, 2006

As always, COPLFR appreciates the opportunity to provide input on such matters, and we are available to continue to work with your group and others at the NAIC to achieve the best solution for these matters.

Sincerely,

Nancy Watkins, Chair
Committee on Property and Liability Financial Reporting
American Academy of Actuaries