Presentation to

Senate Select Committee

On

Workers' Compensation Rates and Premiums

Texas Department of Insurance
October 12, 2004

How Did Texas Get to Its Current Workers' Comp Rating System?

The Rating System Prior to 1992

- **All rates and rating plans promulgated by the Board of Insurance, with very little opportunity for deviations**
- **Rates high and increasing, and loss experience poor**
- **Assigned risk plan represented approximately 25% of the total market**
- **Largest WC carrier withdrew in 1989, and was declared insolvent in 1991**
- **Other carriers withdrew or limited writings**
- **The WC market in Texas was dysfunctional and in crisis**

How Did Texas Get to Its Current Workers' Comp Rating System? (con't)

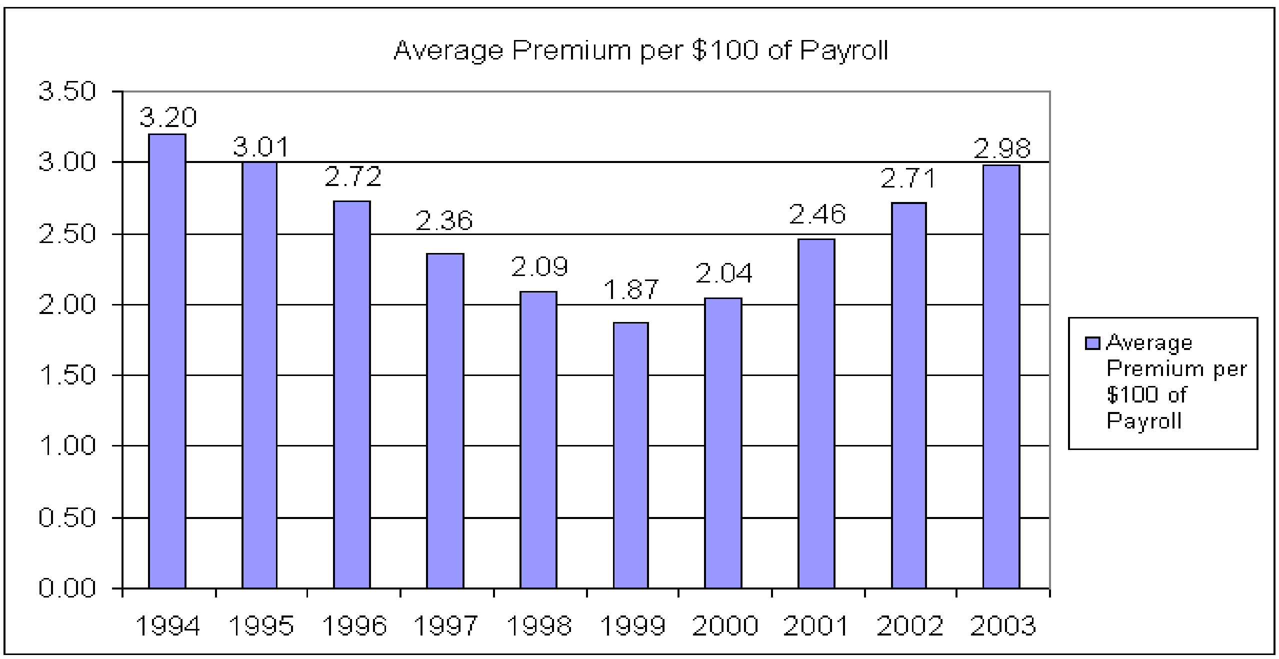
<u>The Rating System Introduced in 1991/92</u>

- **WC benefit structure changed to reduce costs**
- **The Texas Workers' Compensation Insurance Fund (now the Texas Mutual) created to promote competition and serve as the insurer of last resort**
- **Insurers allowed to establish own rate levels on a file-and-use basis**
- **Rating programs such as schedule rating and deductibles allowed to promote safety and to provide for enhanced competition**
- **In essence, the structure of the market changed from a closely state-administered system to open competition, with competition as the regulator**

Texas Workers' Compensation

Average Premium by Policy Year: 1994-2003

Policy Year	Average Premium per $100 of Payroll including all premium adjustments except deductibles
1994	3.20
1995	3.01
1996	2.72
1997	2.36
1998	2.09
1999	1.87
2000	2.04
2001	2.46
2002	2.71
2003	2.98



- The average premiums reflect insurers' manual rate deviations, experience rating, schedule rating, expense and loss constants, the effect of retrospective rating and premium discounts.

- Since workers compensation is an audit line (that is, premiums are based on audited payrolls), the indicated average premiums may change over time, especially for the most recent years.

- The average premiums do not reflect the effect of discounts due to deductible policies, nor do they reflect policyholder dividends.

- Averages are based on data reported in the 12/31/2003 Texas Workers' Compensation Financial Data Call and material taken from the 2003 Class Relativity Study.

- Policy Year is the result of all policies effective during a given Year

Overview of the Policy Pricing Process

- **Each individual job description is assigned to a class code**
- **Each class code is assigned a “riskiness” relativity based on industrywide experience**
- **Each company determines its overall premium need based on its experience and expresses this as a percent deviation from the relativities**
- **The premium for each policy is modified to reflect the individual employer’s experience**
- **Each policy’s premium can be further modified through the selection of deductibles**

Tools to Compute Premium

- **Relativity – A reference point promulgated by the Commissioner, which compares relative riskiness of one class code to another.**

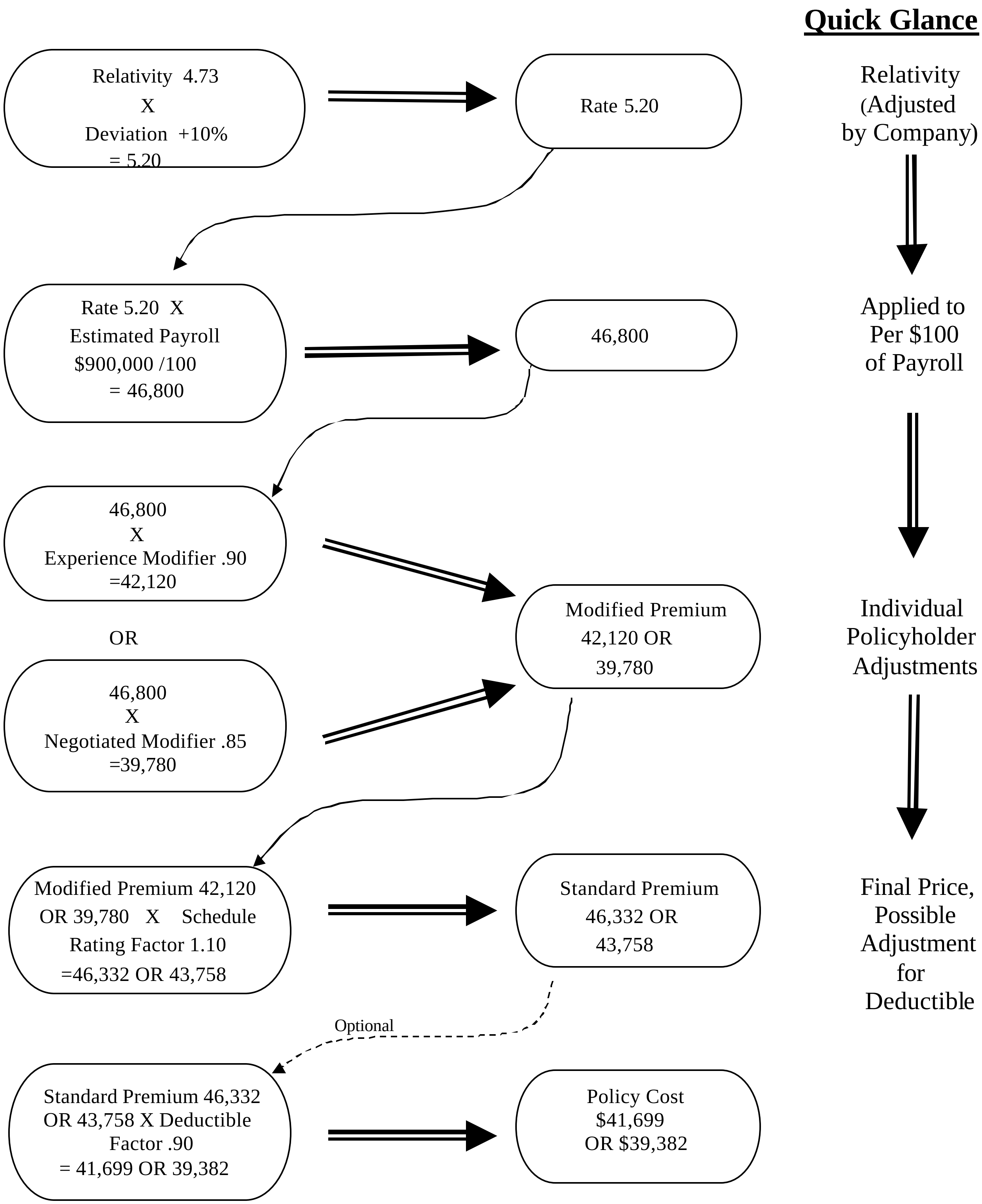
- **Company Deviation – Multiplier filed by each company to express their rates as a percentage of the promulgated relativities. Average company filed deviation for 2003: +12.6%**

- **Experience Modifier – Multiplier applied to each policyholder's premium based on past experience. The modifier is initially calculated under a formula promulgated by the Commissioner, but may be negotiated downward by the insurer.**

- **Schedule Rating – Credit or debit applied to each policyholder's premium to raise or lower it based on criteria filed by each company**

- **Deductibles –Promulgated or negotiated where an insured agrees to reimburse insurance company for part of some or all claims in exchange for a premium credit.**

Workers' Compensation
Simplified Policy Premium Computation
A Hypothetical Numeric Example



-This hypothetical policy is insured with Company A who has a filed deviation of +10%.
Class Code- RESTAURANT NOC with promulgated relativity of 4.73, and payroll of $900,000.
Experience Modifier of .90 OR Negotiated Modifier of .85, and Schedule Rating Debit of 10%
Optional Deductible Credit of 10% for a 10,000 per accident deductible.

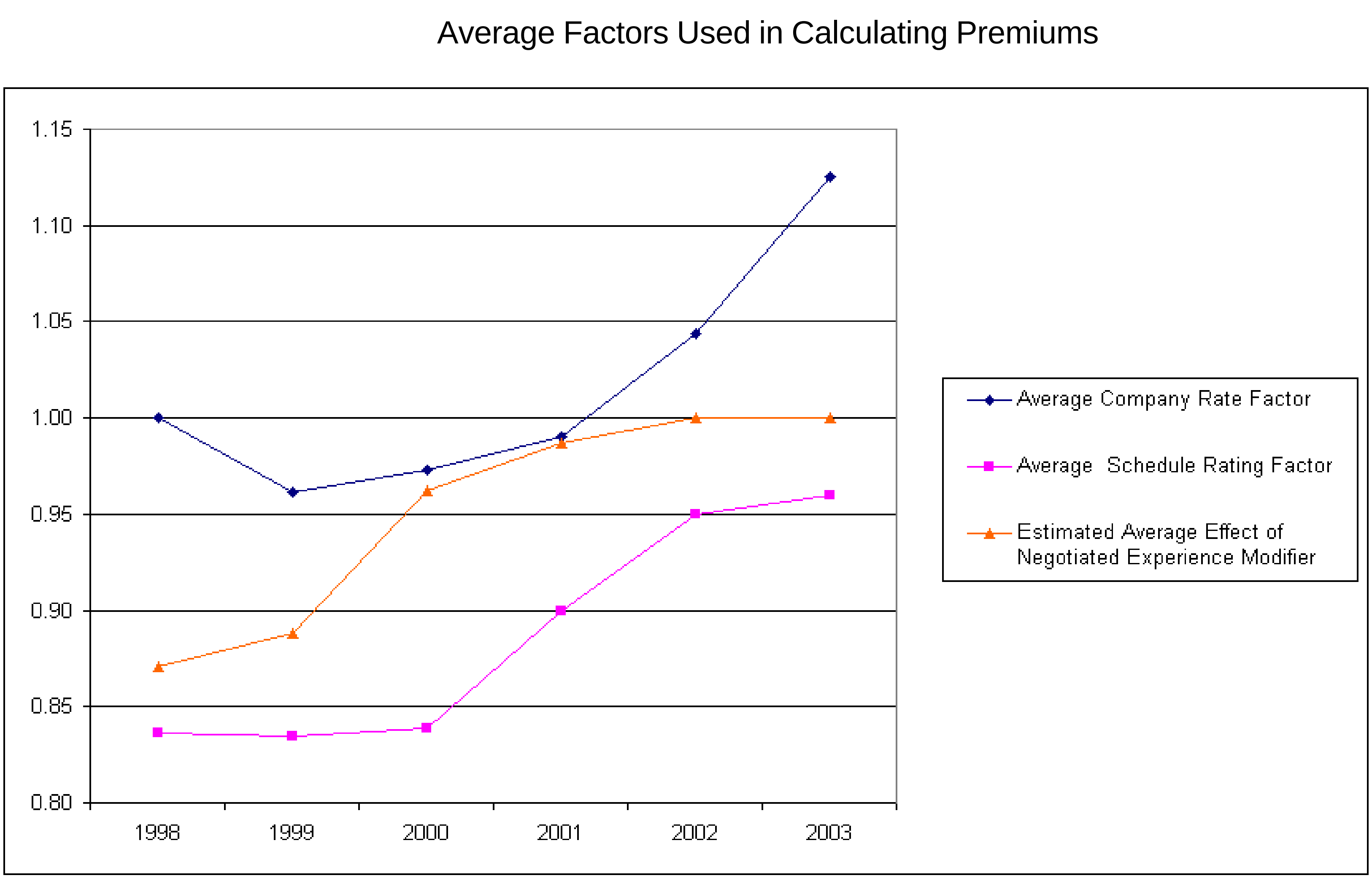
Workers' Compensation Relativity Changes 2001-2005

Top 10 Class Codes by Payroll

Class Code	Description	2001 Payroll	2001 Relativity	2002 Relativity	2003 Relativity	2005 Relativity	Change '02/'01	Change '03/'02	Change '05/'03
8810	CLERICAL OFFICE EMPLOYEES NOC	76,574,675,579	0.52	0.52	0.52	0.46	0.0%	0.0%	-11.5%
8742	SALESPERSONS, COLLECTORS OR MESSENGERS - OUTSIDE	14,748,686,868	0.98	0.96	0.91	0.75	-2.0%	-5.2%	-17.6%
8809	EXECUTIVE OFFICERS NOC	5,321,544,952	0.60	0.64	0.68	0.55	6.7%	6.3%	-19.1%
8868	COLLEGE: PROFESSIONAL EMPLOYEES & CLERICAL	4,989,365,709	0.98	1.03	1.11	1.14	5.1%	7.8%	2.7%
8832	PHYSICIAN & CLERICAL	4,325,001,747	0.82	0.82	0.86	0.77	0.0%	4.9%	-10.5%
8017	STORE: RETAIL NOC & DRIVERS	4,227,622,513	4.16	3.90	4.06	4.13	-6.3%	4.1%	1.7%
8833	HOSPITAL: PROFESSIONAL EMPLOYEES	3,628,085,164	2.27	2.35	2.46	1.95	3.5%	4.7%	-20.7%
8391	AUTOMOBILE REPAIR SHOP	3,206,891,192	4.54	4.46	4.70	4.58	-1.8%	5.4%	-2.6%
8803	AUDITOR, ACCOUNTANT	3,083,158,204	0.21	0.19	0.18	0.17	-9.5%	-5.3%	-5.6%
8820	ATTORNEY	3,051,302,648	0.43	0.41	0.40	0.33	-4.7%	-2.4%	-17.5%

Where Do Average Premium Changes Come From?

Rate Changes are Not Necessarily the Only Thing that Produce Premium Changes



-Effect of Changes in Factors on Premium from 1998-2003: Rate Factor change of 12.5%, Schedule Rating Factor change of 14.8% and Negotiated Experience Modifier change of 14.8%.

SCHEDULE RATING PLAN

The premium for a risk may be modified in accordance with the following schedule rating table, subject to an aggregate maximum modification of ±40% to reflect those characteristics of the risk that are not reflected in the experience of the risk.

	General Categories	Modification Range		
		Credit		Debit
A.	Premises - Care & Condition	10%	to	10%
B.	Classification Peculiarities	10%	to	10%
C.	Medical Facilities	5%	to	5%
D.	Safety Devices	5%	to	5%
E.	Employees – Selection, Training, Supervision	10%	to	10%
F.	Management			
	a. Cooperation with Insurer	5%	to	5%
	b. Cooperation with Safety organization	5%	to	5%

1. All risks are eligible for rating on this plan.
2. The amount of schedule credit or debit shall be applied in a multiplicative manner, after any applicable experience modification and before the application of premium discount and expense constant.
3. All schedule credit or debits shall be based on evidence that is contained in the file of the insurance carrier at the time the schedule credit or debit is applied.
4. The effective date of any schedule credit or debit shall not be any date prior to the receipt in the insurance carrier's office of the evidence supporting the credit or debit.
5. The derivation of the schedule credit or debit must be made available to the risk upon request. To the degree that the risk can correct the reason for any schedule debit to the satisfaction of the insurer, the debit may be removed effective the date documentation for correction is received in the insurance carrier's office.

Other Tools

Negotiated experience modifiers and negotiated deductibles are other tools used by insurers in addition to schedule rating, to modify the premium.

Used less extensively but anticipate that they will be used again once the market softens.

Companies are not required to file their negotiated experience modifiers or deductibles for approval with the Department.

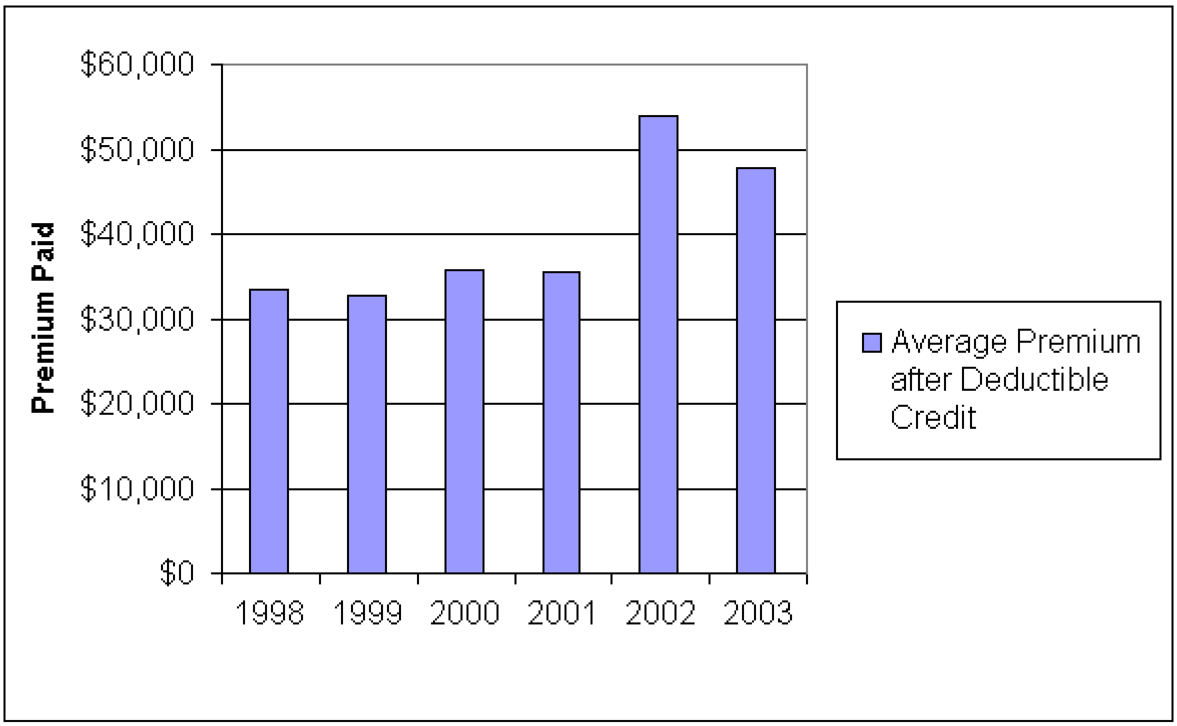
- **Negotiated Experience Modifiers**
    - **Not used much anymore.**

- **Negotiated Deductibles**
    - **Average premium credit of approximately 76%.**
    - **Less than 2.5% of policies written with negotiated deductible plan, but these represent approximately half the statewide premium prior to deductible credits.**

Texas Workers' Compensation
Average Negotiated Deductible Plan

Hypothetical Policy with $200,000 in Premium before Deductible

Year	Average Premium after Deductible Credit	% Change in Actual Premium
1998	$33,515	
1999	$32,630	-2.6%
2000	$35,817	9.8%
2001	$35,450	-1.0%
2002	$53,878	52.0%
2003	$47,772	-11.3%



Actual Data

Year	Premium on Direct Policies Written Prior to Deductible Credit	Premium on Direct Policies After Deductible Credit	% of Reduction in Premiums
1998	$1,645,323,324	$275,717,133	83.24%
1999	$1,799,073,778	$293,520,218	83.68%
2000	$1,711,237,166	$306,458,678	82.09%
2001	$1,950,835,962	$345,783,748	82.28%
2002	$1,815,132,832	$488,982,374	73.06%
2003*	$2,143,768,351	$512,057,553	76.11%

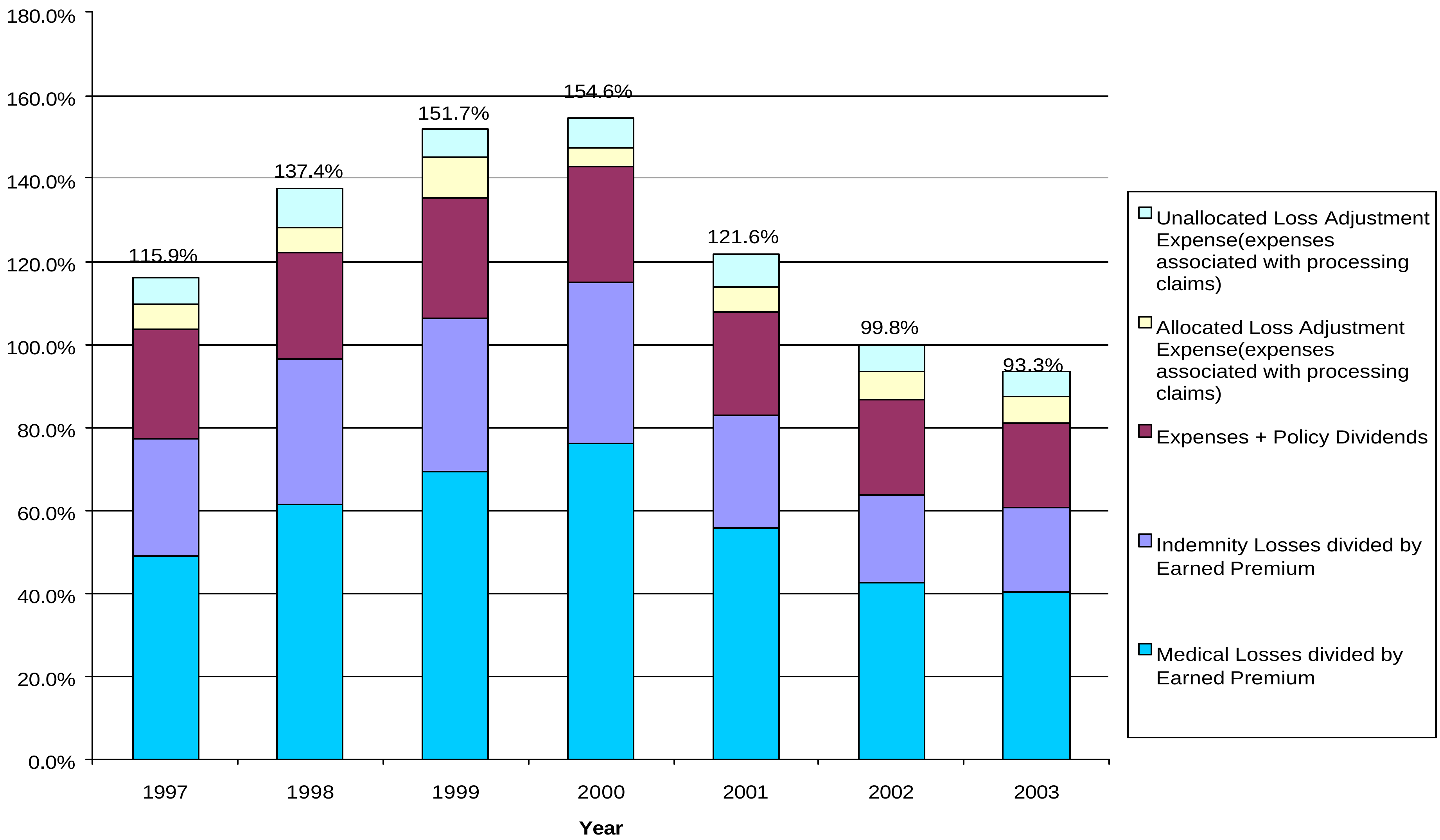
*2003 data is estimated

Preliminary

Texas Workers' Compensation

Combined Ratio by Accident Year

Reflects Ultimate Payouts as Percent of Premium



Combined ratio is the sum of losses and expenses; it does not include investment income.
The numbers exclude large deductible policies that are excluded from the Financial Data Call.

Combined Ratio by Accident Year

Explanation of Columns

Accident Year

Method of compiling data for losses resulting from accidents which occurred in a given year, regardless of when the losses are reported or paid. For example, accident year 1999 would reflect claims or losses from all accidents that happened in 1999 even if the loss was not reported to the company until year 2000. All payments associated with the accident are associated with accident year 1999. For example, payments made in year 2002 that stem from the accident are attributed to accident year 1999.

Direct Earned Premium

Amount of premium actually earned prior to the payment of policyholder dividends and gross of deductible credits in a given period. For example, the 1999 direct earned premium represents premium collected to cover the accident year 1999 claims.

Ultimate Losses

Ultimate incurred losses are the estimate of what claims from a given accident year may cost when finally settled. It may take several years for a claim to be settled because there may be ongoing payments for treatment. Based on past changes in payout amounts, accident year losses can be adjusted to reflect a final expected or ultimate payout amount. Losses are gross of deductible recoveries.

Loss Ratio

Equals the ultimate losses divided by the direct earned premium.

Allocated Loss Adjustment Expense (ALAE) (% EP)

Expenses incurred in investigating and settling claims that can be tracked back to a single, specific claim, such as the bill from one lawyer who was retained to work on one case. These expenses are then shown as a percentage of the direct earned premium.

Unallocated Loss Adjustment Expense (% EP)

Expenses incurred in settling and investigating claims that are not directly tracked back to a single, specific claim, such as claims department salaries. These expenses are then shown as a percentage of the direct earned premium.

Expense and Policyholder Dividends

These expenses include commissions, other acquisition expenses, general expenses, taxes, licenses and fees, and policyholder dividends. These expenses are shown as a percentage of the direct earned premium.

Combined Ratio

The combined ratio is the sum of the loss ratio, ALAE ratio, ULAE ratio, and the expense and policyholder dividend ratio. A combined ratio of less than 100% indicates that the company earned a profit on its insurance operations. A ratio greater than 100% indicates a loss on insurance operations, before considering investment income. In particular, the combined ratio does not reflect profits or losses on investment income.

Combined Ratio by Accident Year

Accident Year	Direct Earned Premium	Ultimate Losses	Loss Ratio	ALAE (% EP)	ULAE (% EP)	Expense +Pol Div	Combined Ratio
1997	1,389,819,130	1,074,913,438	77.34%	6.1%	6.2%	26.3%	115.9%
1998	1,384,402,435	1,333,775,024	96.34%	6.0%	9.1%	25.9%	137.4%
1999	1,448,202,421	1,536,214,351	106.08%	10.0%	6.6%	29.1%	151.7%
2000	1,458,232,049	1,674,714,968	114.85%	4.2%	7.5%	28.1%	154.6%
2001	1,876,788,712	1,554,839,003	82.85%	6.0%	7.6%	25.1%	121.6%
2002	2,086,855,389	1,324,443,350	63.47%	6.4%	6.6%	23.4%	99.8%
2003	2,123,598,843	1,287,751,728	60.64%	6.5%	5.8%	20.4%	93.3%

Notes:

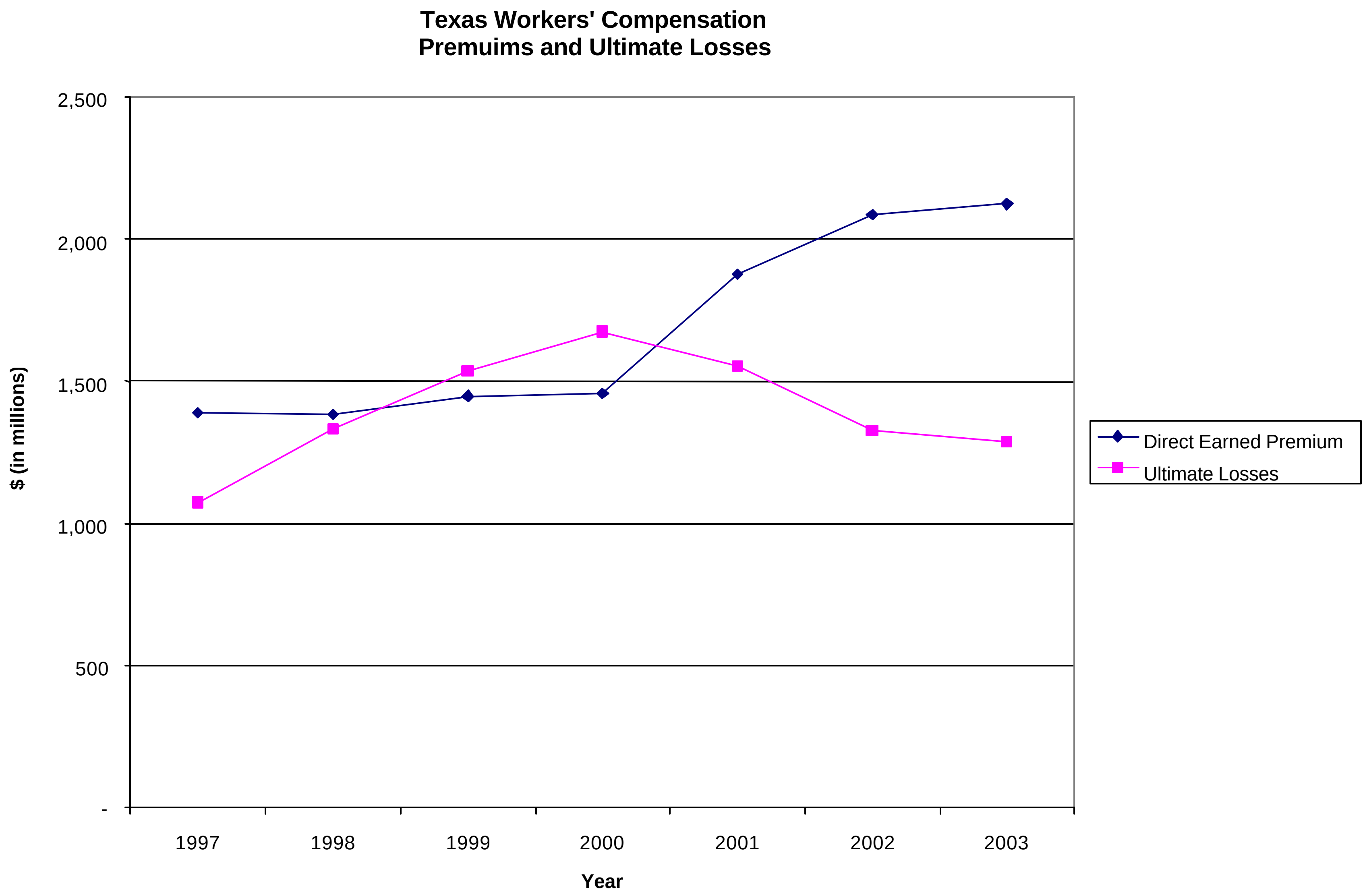
Data from Preliminary NCCI Financial Data Call, TX Compilation of Page 14/15 and TX Compilation of IEE.

The numbers exclude large deductible policies that are excluded from the Financial Data Call.

New ALAE and ULAE definitions in 1999 explain the large changes from 1998.

Loss development factors used in obtaining the ultimate losses are from the Finaincial Data Package as of Dec '02.

Kemper group is not included in 2003 expense data since they are in runoff.



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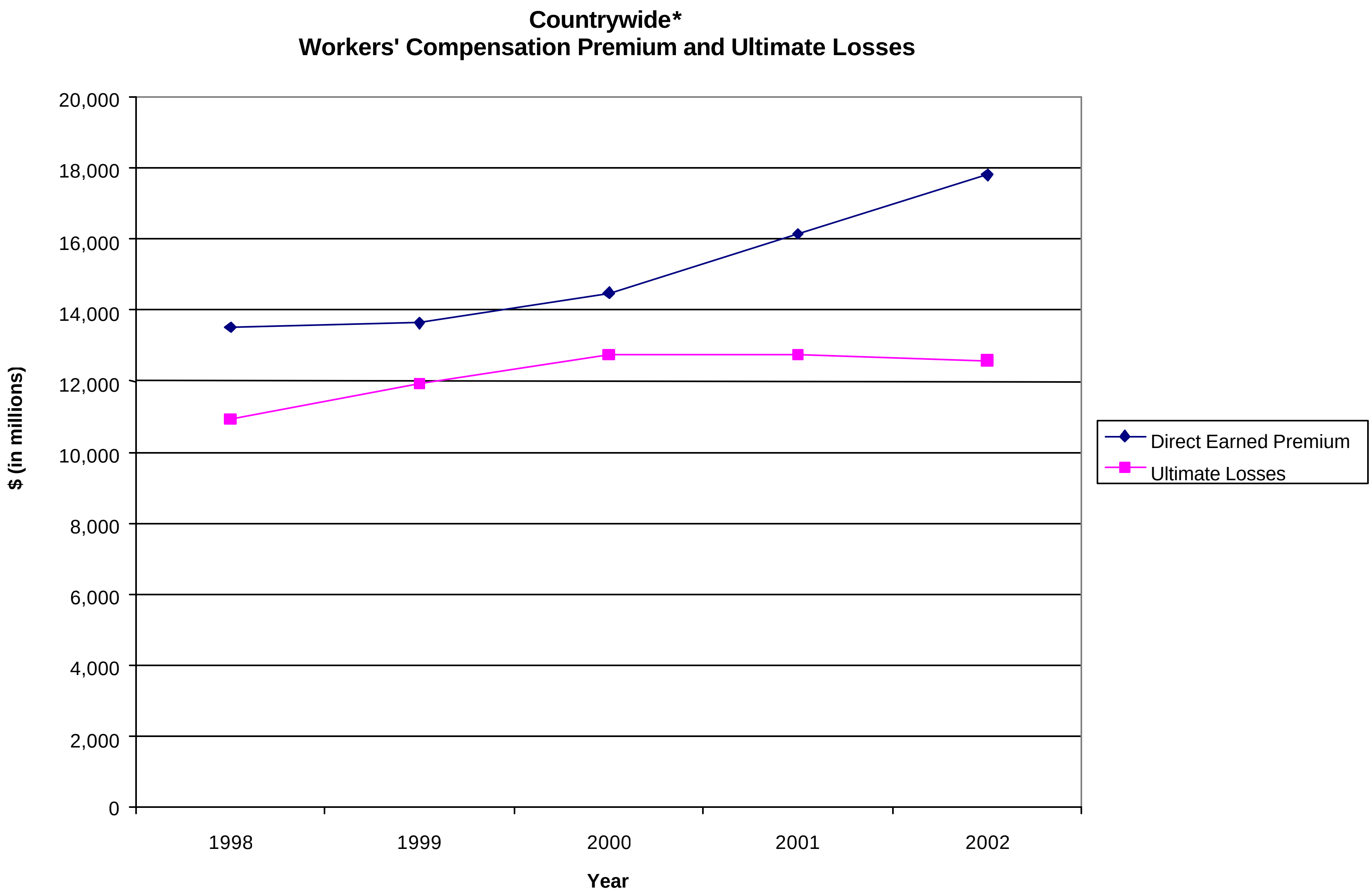
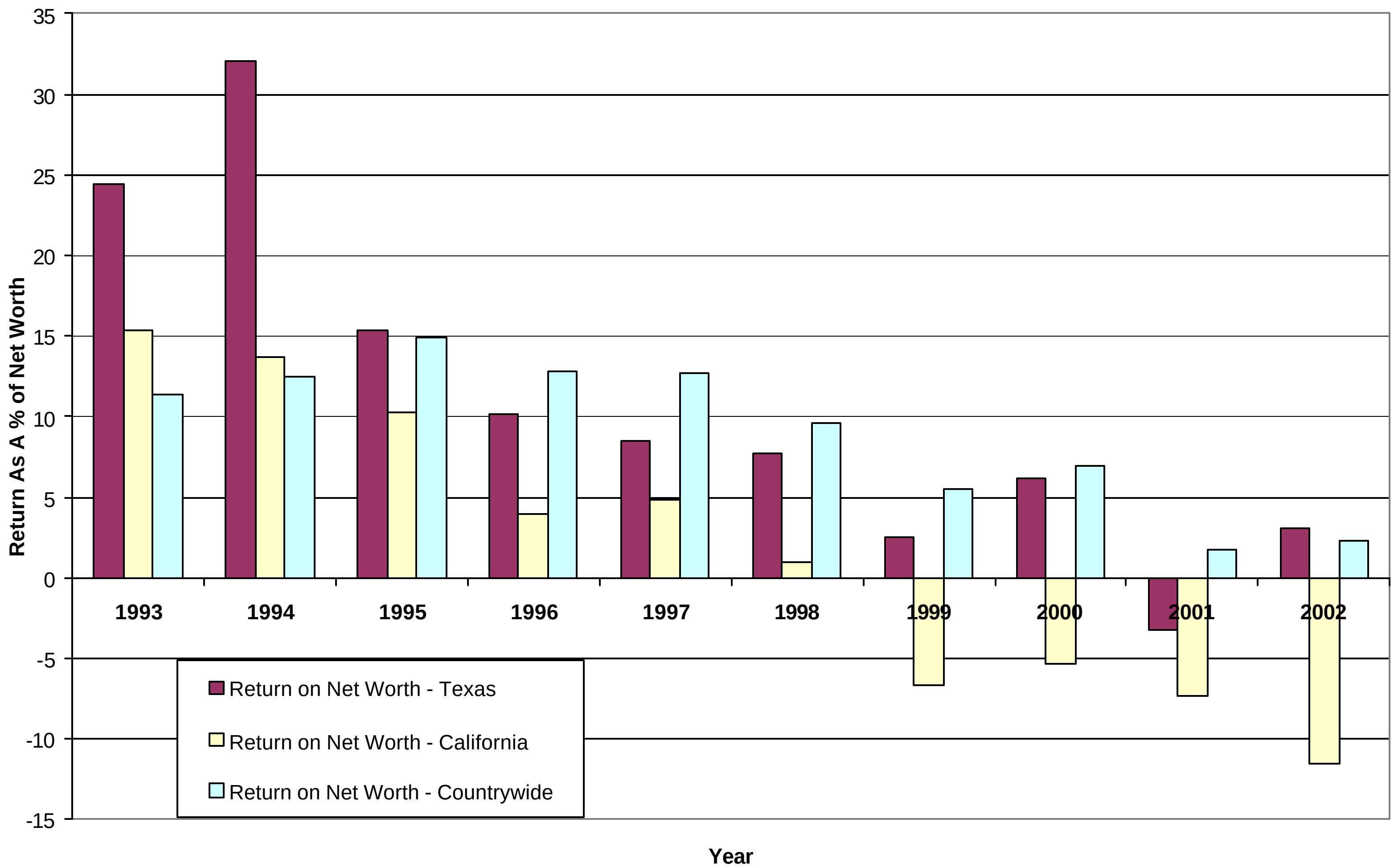


* Only states that NCCI has data for are included. Many states such as California and New York are not included.

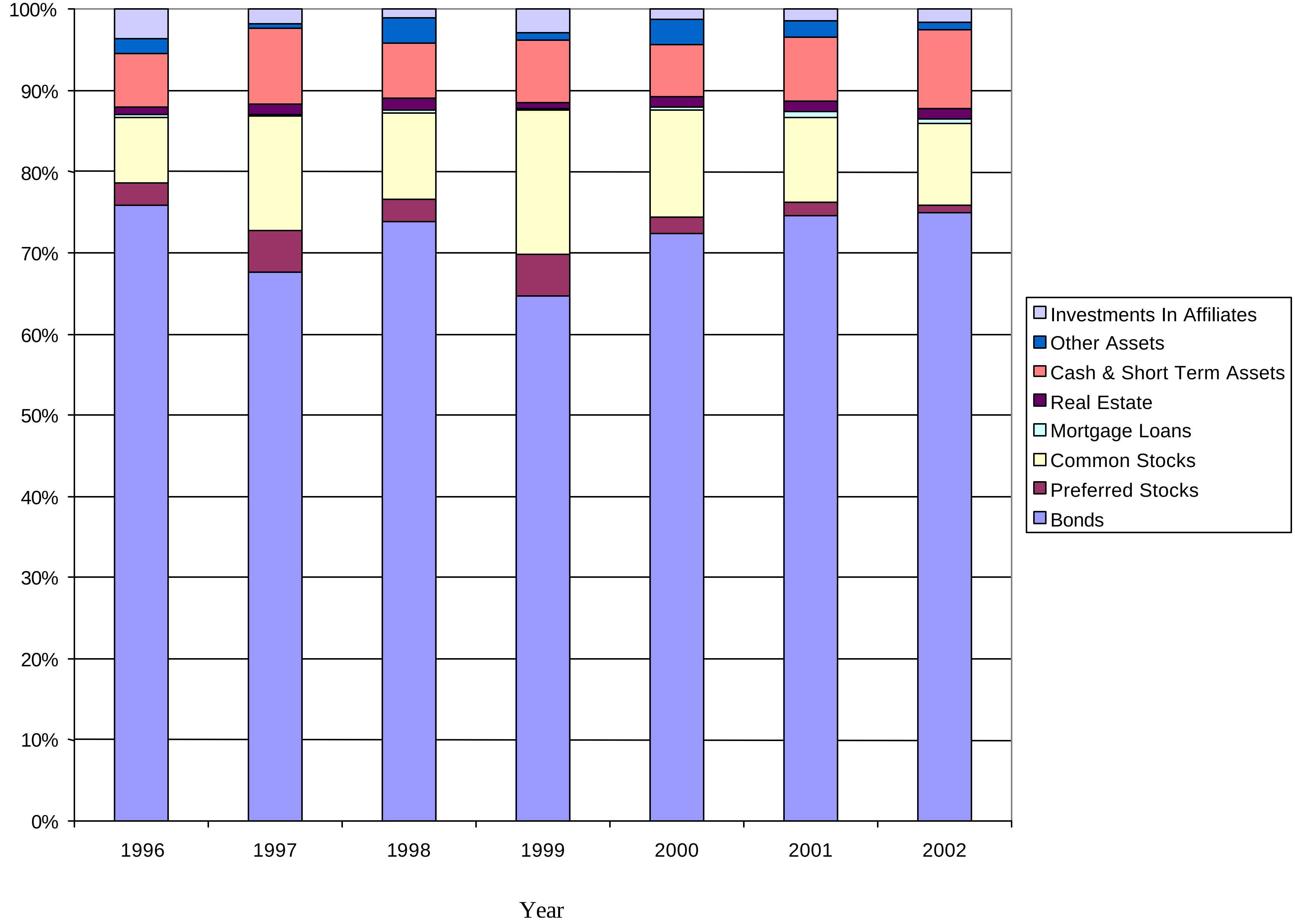
Source: NCCI

TEXAS WORKERS' COMPENSATION
10-YEAR HISTORY OF INDUSTRY RATE OF RETURN ON NET WORTH



Source: NAIC 2002 Profitability by Line by State

SUMMARY OF INVESTABLE ASSETS DISTRIBUTION
WORKERS' COMPENSATION PREDOMINATING COMPANIES



Source: Bests Aggregates and Averages 2003-1997 Editions