Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 04/2005 – "Understanding Your Experience Modification: What You Need to Know" April, 2005

Understanding Your Experience Modification: What You Need To Know

By Jeffrey W. Cavignac, CPCU, RPLU, CWCA

What is an experience modification and how does it affect you?

Insurance is based on the theory of spreading or sharing risk by members of a group who are likely to experience losses. The losses of an entire group can be predicted with a fair degree of accuracy; however, it is not possible to determine which group members will actually suffer a loss. Because of this, the cost of insurance is apportioned to each member on the basis of average cost for the group. It is assumed that over time, each member's experience will approximate the average.

In reality, very few risks are "average." Some are much worse, and others are much better. A method is needed to allocate costs appropriately among various members of the group and at the same time provide incentives to reduce employee-related accidents.

The experience rating or modification compares an employer's claims history with those of other employers in the same industry. Insurance Code Section 11730(c) defines **experience rating** as *"a rating procedure utilizing past insurance experience of the individual policyholder to forecast future losses by measuring the policyholder's loss experience against the loss experience of policyholders in the same classification to produce a prospective premium credit, debit or unity modification."*

As mentioned above, the experience modification has two purposes. First of all, it attempts to adjust premium levels so that the amount that an employer pays will be sufficient to cover its losses as well as the expenses incurred by the insurance company in the process of handling the employer's workers compensation program.

Secondly, it provides the employer with an incentive to reduce losses by awarding a credit for favorable loss experience or imposing a debit for poor loss experience.

How does it work?

Who is eligible? Every policyholder in the state of California that meets a minimum threshold is eli-

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gible for an experience modification in 2005. In order to qualify for an experience modification, the employer would have had to generate $28,737 of premium during the experience period. Note that "premium" in this context means applicable payroll multiplied by pure premium rates, not what you actually paid.

The **experience period** is basically the last four years, excluding the current year. (The actual "experience period" can be a little more complicated if you have had a shortened policy period during the last four years and nine months. However, if your normal anniversary date has remained unchanged, then the experience period is as described.) For example, if an employer's policy renewed on January 1, 2005, the experience period would be between January 1, 2001 and January 1, 2004.

How does the formula work? In simple terms, your "actual losses" are divided by "expected losses" and the resulting factor is your experience modification. "Expected losses" are the dollars of loss that an average employer in a specific line of business would be expected to have, given the amount of payroll reported.

If an employer's losses are lower than average, that would generate a credit modification – a mod under 100. If an employer's losses are higher than average, that would generate a debit modification, which would be over 100%. Every insurance company writing coverage is required by law to use this experience modification.

How does the Bureau Experience Rating Form work?

As we review this rather complex arithmetic calculation, please refer to the Experience Modification Worksheet on page three of this newsletter.

Expected Losses

Expected Losses are calculated by taking payroll for the applicable classifications for each of the three years in the experience period, totaling it, and

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Top Ten Things You Can Do to Lower Your Ex Mod

1. Develop formal hiring practices
2. Utilize Pre-Interview Questionnaires, job descriptions and job performance tests
3. Implement an effective and visible Injury and Illness Prevention Program (IIPP)
4. Start a Safety Incentive and Safety Consequence Program
5. Utilize a formal Medical Clinic Assessment Program
6. Install a formal First Aid Program with your medical clinic
7. Develop and implement an effective Early Return To Work Program with your staff and the medical clinic
8. Implement a formal Claim Reporting Program
9. Install Post Accident Response Training (P A R T)
10. Conduct ongoing injury and claim management with your agent, insurance carrier, and the injured employee

2005 Training Sessions

Cavignac & Associates' Training Room
Bank of America Plaza
450 B Street, 18th Floor, San Diego, CA

- **Sexual Harassment Training (AB 1825 Compliant)**
  Thursday, May 12th, 11:30 AM—1:30 PM
- **Fleet Safety**
  Friday, May 13th, 9:00—11:00 AM
- **Fall Protection Program & Personal Protective Equipment**
  Friday, July 22nd, 9:00—11:00 AM
- **Sexual Harassment Training (AB 1825 Compliant)**
  Friday, August 5th, 9:00—11:00AM
- **Workers Compensation Claims Management**
  Friday, September 16th, 9:00—11:00AM
- **IIPP: How to Set Up an Effective Training Program**
  Friday, November 4th, 9:00—11:00AM

All training sessions available to our clients / seating is limited

Contact **EILEEN JOLLY** by e-mail **ejolly@cavignac.com** or by phone at **619-744-0551** for information about upcoming training sessions.

Prepared for:

Mighty Fine Architecture

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EXPECTED LOSSES

CLASS CODE	2003 PAYROLL	2002 PAYROLL	2001 PAYROLL		ELR	EXPECTED LOSSES	"D" RATIO	PRIMARY EXP LOSSES
8601	409,606	385,095	461,545		0.57	7,161	0.19	1,361
8810	603,203	398,271	432,684		0.45	6,454	0.19	1,226

SAMPLE

Experience Modification Worksheet

EXPECTED EXCESS (f)=(d)-(e)	EXPECTED LOSSES (d)	PRIMARY EXP LOSSES (e)
11,028	13,615	2,587

ACTUAL LOSSES

CLAIM NUMBER	TYP INJ	O F	PLCY YEAR	ACT INCURRED LOSSES	PRIMARY ACT LOSSES	CLAIM NUMBER	TYP INJ	O F	PLCY YEAR	ACT INCURRED LOSSES	PRIMARY ACT LOSSES
111111	N	O	2002	39,301	7,639	222222	N	O	2002	29,781	7,287

ACTUAL EXCESS (c)=(a)-(b)	ACTUAL INCURRED LOSSES (a)	PRIMARY ACT LOSSES (b)
54,156	69,082	14,926

RATING PROCEDURE

TOTAL PRIMARY ACTUAL (b)	"B" VALUE	"W" VALUE	RATABLE EXCESS LOSSES =W x (c)	(1-W) x (f)	TOTAL (g)
14,926	10,000	0.00	0	11,028	35,954

13,615 TOTAL EXPECTED LOSSES (d)	10,000 "B" VALUE	23,615 TOTAL (h)	152 % EXPERIENCE MODIFICATION (g)/(h)

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multiplying the total (divided by 100) by an Expected Loss Rate (ELR).

Expected Loss Rates are published by the Bureau. Rates vary by classification. In the exhibit there are two classifications: Code 8601 is "Engineers and Architects," and Code 8810 is "Clerical." The ELR for 8601 is .57. This means that for every $100 of payroll you can expect 57¢ of losses.

Both 8601 and 8810 have relatively modest ELRs. In comparison, some construction classifications can be in the $15-$30 range.

Expected Losses, in turn, are divided between **Primary Expected Losses** and **Expected Excess Losses**. In order to arrive at Primary Expected Losses, multiply expected losses by what is known as a **D Ratio** (the D Ratio is published by the Bureau).

Total the columns for Expected Losses (d) and Primary Expected Losses (e). Subtract (e) from (d) to obtain Expected Excess Losses (f).

Actual Losses

Your **Actual Losses** are shown in the next table. Claim #11111 incurred a loss of $39,301. However, the rating formula discounts severity and penalizes frequency. Although this claim has an "Actual Incurred Loss" value of $39,301, the Primary Actual Losses go in at $7,639. This discount is taken from a table published by the Bureau.

The Bureau also tracks type of injury. There is a column entitled "O" or "F." "**O**" stands for **Open**, and "**F**" stands for **Final**. In this instance, Claim #11111 was still open at the time the modification was calculated. Finally, the Policy Year references the year in which the claim took place (11-01-02/03 for Claim #11111).

Total the columns for Actual Incurred Losses (a) and the Primary actual Losses (b). Subtract (b) from (a), which will give you the Actual Excess Losses (c).

Rating Procedure

The calculation is the final element of the worksheet. Remember that you are taking actual experience and dividing it by expected experience.

Total Primary Actual and Total Expected Losses come straight from the tables above.

The **Ballast**, or "**B**" value, is calculated by the Bureau and placed in the top and bottom portions of the formula to move all mods closer to 1.0. In other words, it stabilizes the values. Without the "B" value, experience modification fluctuations would be much greater than they are. For example, if you did not include the "B" value on this experience modification, the mod would increase from 152% to 174%.

A **Weighting Value**, or "**W Value**" is utilized in the experience rating formula to determine the percent of actual excess losses to be used in the calculation. The W Values for smaller companies (as is the case here) can be zero. The larger the company, the higher the W Value. This recognizes that excess losses, especially for smaller companies, are less "credible." The larger the firm, the more control it should have over excess losses, which is why they are factored into the equation for larger firms.

Ratable Excess Losses are the actual excess losses (c) multiplied by the W Value. In our example, since the W Value is "0," the Ratable Excess Losses are 0.

The final item in the numerator (the top part of the equation) is calculated by taking 1-W and multiplying it by the Expected Excess Losses (f). In this case, since W = 0, this item is the same as Item (f).

When you divide the top and the bottom figures, the result is the employer's experience modification. In this case, it is 152%.

The Bureau's rating formula *discounts* SEVERITY and *penalizes* FREQUENCY

Remember that the formula penalizes **Frequency** and discounts **Severity**. In other words, an employer is supposed to have more control over "claim frequency" as opposed to "claim severity."

For example, if the employer represented by the attached worksheet had 15 $2,000 claims (Actual Incurred Losses of $30,000), its experience mod would be 204%. If that same employer had one $30,000 claim, its experience modification would be 115%. The actual premium of the sample employer is approximately $30,000. This difference between 115% and 204% equates to more than $26,000 to the employer's bottom line each year for

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three years , despite the fact that the Total Incurred Losses were the same.

Note that if the employer had no claims, its modification would be 89%.

What does this mean to you?

Ultimately, you end up paying for your own losses. The experience modification ensures that those who suffer more losses than others pay a higher premium. As an example, if Mighty Fine Architecture had a unity or 100% modification, it would pay approximately $30,000 in premium.

However, let's assume that in one year Mighty Fine had five $2,000 claims for a total incurred loss of $10,000. Remember the employer's premium is $30,000 and it's had $10,000 in claims. This generates a loss ratio of approximately 33%, which isn't too bad, but what impact will claim frequency have on the firm's experience modification?

These five claims take the modification from a "best-case scenario" of 89% to 131%. This is a 42-point fluctuation, and equates to $9,300 per year in higher premium. Remember that the employer will have to pay this increase for ***three*** years. In other words, due to loss frequency, $10,000 in claims ultimately will cost the firm $27,900. This alone is incentive enough to actively manage your workers compensation costs.

Your workers compensation experience modification will have a huge impact on what you pay for workers compensation insurance. The only way to lower your insurance premium in this area is to reduce your underlying costs. Cavignac & Associates has developed a Workers Compensation Management Program designed to lower these costs. The sidebar to this article highlights some of those techniques.

The more you understand your experience modification and how it is calculated, the better you can control it. We would welcome the opportunity to answer any questions you might have.

Disclaimer: *This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.*

MS Walk Results

On April 10, 2005 Cavignac & Associates' 35 Team members raised a total of $6,365 for the annual MS Walk in San Diego.

Thanks to all of you who joined or sponsored our Team members and helped to make the 2005 MS Walk a great success!

HIPAA Basics

Your Right to Privacy

In December 2000, the U.S. Department of Health and Human Services released final regulations that place restrictions on how personally identifiable health information may be used and disclosed by certain organizations.

These regulations implement the privacy requirements contained within the Administrative Simplification subtitle of the Health Insurance Portability and Accountability Act of 1996 (HIPAA).

While some states have laws that protect health information, this federal regulation establishes a uniform, minimum level of privacy protections for all health information. In most cases, the final rules were effective April 14, 2003.

In summary, the HIPAA Privacy Rules:

- Set limits on how health information may be used and disclosed
- Require that individuals be told how their health information will be used and disclosed
- Provide individuals with a right to access, amend or copy their own medical records
- Give individuals a right to receive an accounting of disclosures, to request special restrictions, and to receive confidential communications
- Impose fines where the requirements contained within the regulations are not met