National Council on Compensation Insurance, Inc.

FAQ's ON NCCI'S EXPERIENCE RATING PLAN CHANGES

In 2011, NCCI proposed a national filing, Item E-1402, to update the Experience Rating Plan (Plan). This filing has been approved in 39 states including all NCCI states plus some of the independent bureau states. Further information is provided below:

Background

- The current experience rating split point contained in the Plan has not changed in more than 20 years
- The average cost of a claim has tripled since the last split point update. This means less weight is being given to each employer's actual experience
- Over time, the Plan has become less responsive - modifications have drifted closer to a unity (1.0) modification
- A modification to the Plan is needed to restore the equity of the Plan

Impact

- Overall changes in experience modifications will be revenue neutral
- There will be changes for individual employers experience modifications, but the average experience modification across all employers will remain the same
- In general, experience credits will become larger credits and experience debits will become larger debits

For a better understanding of the proposed changes in Item E-1402, please review the following Frequently Asked Questions (FAQs):

FAQ'S EXPLAINING THE PROPOSAL

1. **What is an experience rating split point?**

   In the promulgation of an experience rating modification, a split rating approach is used to reflect both the frequency and severity of losses. Currently, the split of actual incurred losses used in the experience rating calculation is applied as follows:

   - The amount of the loss up to $5,000 is known as the primary loss, which reflects frequency
   - The amount of the loss in excess of $5,000 is known as the excess loss, which reflects severity

   Under this split rating method, actual primary losses are given full weight in the experience rating formula, while actual excess losses only receive partial weight. The dollar value—which splits a loss into its primary and excess portions, currently $5,000—is known as the primary/excess split point.

2. **Why does the experience rating split point need to change?**

   Since the last split point update occurred more than two decades ago, the average cost of a claim has tripled. Because of this, the portion of each claim that flows into the experience rating formula at full value (primary loss amount) is much smaller than what it was 20 years ago. The result is that the Plan is giving less weight to each employer's actual experience. Consequently, the Plan formula has become less responsive. To address this issue, a transition plan to increase the split point amount over time is being proposed.

3. **What is the proposed experience rating split point transition plan?** The proposed transition plan is:

   - Year 1: The split point will initially be increased to $10,000, to become effective with each state's approved rate/loss cost filing on or after January 1, 2013
   - Year 2: A state's next effective year filing will further increase the split point to $13,500
   - Year 3: A state's third effective filing year will further increase the split point to $15,000 plus two years of inflation adjustment (rounded to the nearest $500)

4. **Why use a 3-year transition rather than a longer period?**

   While it is very important to restore equity to the Plan, NCCI also considered that particularly for those employers that will see bigger debits, change is best accomplished by a slow measured approach. And as a result, NCCI proposed a three year transition plan to spread the full impact of the split point change over three years. A longer transition plan was considered, but rejected for equity reasons. A longer transition period delays resolution of a significant equity issue – it gives more weight to the interests of the 22% of employers countrywide that will see bigger debits than to the 78% of employers countrywide who will experience little impact or who will see bigger credits.

5. **What index will be used to adjust the split point in year three and beyond?**

   The current indicated value of the split point as of 2013 is $15,000, but this value will change over time to reflect changes in claim costs. NCCI will be applying an inflation adjustment to the indicated value of $15,000 in year three and beyond. The index used to adjust for inflation will measure changes in the countrywide average cost of a claim underlying experience rating modifications in 2013 versus the year for which the updated (indexed) split point is being filed.

   For example:
   - To determine the split point effective 1/1/2015 the index will measure the change in claim costs between Policy Year (PY) 2010 (average claim date underlying 2013 modifications) and PY 2012 (average claim date underlying 2015 modifications)
   - To determine the split point effective 1/1/2016 the index will measure the change in claim costs between PY 2010 (average claim date underlying 2013 modifications) and PY 2013 (average claim date underlying 2016 modifications)

6. **Why index to countrywide severity changes rather than statewide?**

   The Plan is administered on a countrywide basis with a single countrywide split point that does not vary by state. Because of this, it is appropriate to focus the analysis on countrywide data. Using state-specific indices could result in approximately 40 different split points being used, creating an overly cumbersome Plan.

7. **Why now? Has this issue been thoroughly studied by NCCI?**

   Yes. We review the performance of the Plan periodically. Once it became clear that the performance of the Plan could be improved, discussions and planning for the full review of the Plan began approximately in 2005. After extensive research and analysis, the current proposal was submitted in August 2011 to state insurance departments.

FAQ'S EXPLAINING THE IMPACT

8. **What will be the premium impact of increasing the experience rating split point?**

   The proposed split point change will be premium-neutral. That is, the *average* experience rating modification across *all* employers will not change due to an increase in the split point. This is because the change in primary and excess actual losses will be matched by a corresponding change in the primary and excess expected losses used in the experience modification formula. The impact of the split point change will be risk-specific and will vary from risk to risk depending on individual risk loss experience.

9. **What do you mean when you say the average experience rating modification across all employers will not change?**

   When we refer to average experience rating modification, we are referring to a premium-weighted average mod and not a simple straight average mod. In order to make sure total premium is the same, the premium-weighted average mod must stay the same. The distinction is explained in this example:

	Manual Premium	Old 5K Mod	**Old Standard** Premium	New 10K Mod	**New Standard** Premium
Employer 1	100,000	0.96	96,000	0.94	94,000
Employer 2	50,000	1.08	54,000	1.12	56,000
Total	150,000		150,000		150,000
Straight Avg		1.02		1.03	
Premium-wtd Avg		1.00		1.00	

10. **How will the split point change impact individual employers?**

The impact to individual employers will vary according to how many claims the employer has that exceed $5,000. If none of their claims exceed $5,000, they will generally see a decrease in their experience rating modification. This is because no additional actual losses will flow into their experience modification under the higher split point and they will receive the benefit of less expected excess losses in their experience modification calculation. An increase or a decrease in an experience modification will generally depend on whether an employer has a below-average amount or an above-average amount of claims above $5,000. Another general rule of thumb is that credits will tend to get larger and debits will tend to get larger (there will be exceptions to this), but across all risks, they will balance out.

It should also be noted that the new experience rating values will not only reflect the new split point, but they will also reflect the regular annual update of all experience rating values. This further makes it difficult to make broad statements about individual employer modification changes.

11. **Is there any more detail on the impact to employers?**

NCCI looked at the impact of the proposed changes to intrastate modifications effective in 2009. On a countrywide basis, the results were as follows:

- 68.7% of risks would have had the modification reduced by more than 2%.
- 9.4% of risks would have had little or no change (within +/-2%).
- 22% of risks would have had the modifications s increased by more than 2%.

12. **Can NCCI provide experience rating values for 1/1/13 and subsequent in order to calculate the next modification?**

Not yet. The experience rating values for 1/1/13 and subsequent have not been produced yet. The experience rating values that will be used when the new split-point is implemented will be produced and filed with the annual loss costs (rate filings) that will begin to roll out this summer for effective dates starting January 1, 2013 and after. Experience rating values are produced with the loss costs (rates) because they employ the same underlying data and this also allows them to be in sync with the loss costs (rates). The data that will be used in the loss cost/rate filings is still coming into NCCI. Once the loss cost/rate filings are produced and filed starting this summer, the experience rating values will be available. The production timeline for experience rating modifications will be as follows:

- January 2013 experience rating modification factors are generally made available in the July 2012 timeframe. Since rate filings for 2013 are not approved at that time, the rating is produced with current rates and split point information.
- Once the state(s) has approved the loss costs (rate filing), which is typically in the October timeframe (for January rating effective dates), a final modification will be produced using the newly approved values with the updated split point ($10,000 for year 1)

13. Even if 1/1/13 and subsequent experience rating values are not yet available, is there a way to isolate the impact of the split point change on a particular experience rating modification?

Yes. Generally the change in split point does not affect the Expected Loss Rates (ELRs) or the weight/ballast values. It will only impact the Discount Ratio (D ratio) which is a factor applied to the expected losses for each classification. It determines the portion of a risk's expected losses that are expected to be primary losses. An approximation of the impact on an individual insured from the split point filing could be calculated by using the current ELR's, weights/ballasts, combined with increasing the D ratio by 50%, and applying the increased split point of $10,000. A few examples are attached for your reference.

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Unity Mod Risk #1

Loss experience: One $5K claim, one $45K claim

E = $50,000

W = 0.10

B = 30,000

D-ratio = 0.20 at $5K split point

D-ratio = 0.30 at $10K split point

Current Mod $= \dfrac{10K + 40K\ (.10) + 40K\ (.90) + 30K = 1.00}{50K + 30K} = 1.00$

New Mod $= \dfrac{15K + 35K\ (.10) + 35K\ (.90) + 30K = 1.00}{50K + 30K} = 1.00$

Mod Change = 0.0%

Unity Mod Risk #2

Loss experience: Two $25K claims

E = $50,000

W = 0.10

B = 30,000

D-ratio = 0.20 at $5K split point

D-ratio = 0.30 at $10K split point

Current Mod $= \dfrac{10K + 40K\ (.10) + 40K\ (.90) + 30K}{50K + 30K} = 1.00$

New Mod $= \dfrac{20K + 30K\ (.10) + 35K\ (.90) + 30K}{50K + 30K} = 1.06$

Mod Change = +6.0%

<u>Unity Mod Risk #3</u>

Loss experience: Two $5K claims, one $4K claim

E = $50,000

W = 0.10

B = 30,000

D-ratio = 0.20 at $5K split point

D-ratio = 0.30 at $10K split point

$$\text{Current Mod} = \frac{14K + 0(.10) + 40K\ (.90) + 30K}{50K + 30K} = 1.00$$

$$\text{New Mod} = \frac{14K + 0(.10) + 35K\ (.90) + 30K}{50K + 30K} = 0.94$$

Mod Change = -6.0%

14. **Does an experience modification double when the split point goes from $5,000 to $10,000 in the initial year?**

No. Doubling the split point from $5,000 to $10,000 in the initial year does **not** mean that the experience modification will double. This is because the change in primary and excess *actual losses* will be matched by a corresponding change in the primary and excess *expected loss benchmarks* used in the experience modification formula. In addition, the split point change is one of several factors influencing an employer's experience modification calculation. Other factors include:

- The new experience and payroll entering the calculation
- Whether that experience was weighted to a frequency of losses vs. a severity of losses
- Any classification change that may have occurred in the business operation
- NCCI's regular annual update of experience rating values

15. Are small and large employers similarly impacted?

We are estimating that an even greater percentage of small employers will see a reduction in their mods than will medium and large employers.

16. **Is the construction industry more likely to be impacted than others?**

No. Contractors as a whole do not typically have higher modifications than other industries. Currently contractor modifications are the same or slightly lower than the all-industry average modification. Most contractors have credit modifications. Those credits will generally become larger credits under the proposed 10K split point.

17. **If an experience modification effective 1/1/13 or thereafter increases, is that related to the change in the split point?**

Not necessarily. Keep in mind that the larger part of the change in experience modifications may come from other factors not related to the split point change such as:

- A new year of experience added and an old year dropped from the modification calculation
- Development of losses from older years included in the modification calculation
- A change in the expected loss rate (ELR) due to loss cost change for the classes in which the insured has exposure

Other things that may affect the final price the insured will pay include:

- Change in loss cost/rate for the classes in which the insured has exposure
- Change in carrier pricing

18. **When will the experience rating split point change become effective?**

The increase in the experience rating split point cannot begin without state regulatory approval. NCCI filed the proposed change for state regulatory approval in all states where NCCI is the ratemaking bureau. The change has been approved and will become effective on each state's loss cost (rate) filing effective date, beginning with January 1, 2013 filings.

19. **When the split point is changed, does it apply to all claims or only the claims as of that date, for example when the split point is changed to 10,000 in 2013, will it also be applied to claims prior to 2013?**

It will apply to all claims on the experience modification worksheet.

20. **How will the new split point value apply in states that have approved the Experience Rating Adjustment (ERA)?**

Most states previously approved ERA when it was effective in 1998. ERA adjusts medical only losses. When there is a medical only loss, the ERA rules state that the actual incurred loss, actual primary loss, and actual excess loss amounts are reduced by 70%.

After determining the primary and excess loss amounts of a medical-only claim using the new split point value, the primary and excess loss amounts will be reduced by 70%, respectively.

21. **What would have happened to the performance of the Plan if NCCI had not proposed to update the current split point of $5000?**

Over time, the Plan would continue to become less and less responsive. There would be employers who deserve bigger credits and employers who deserve bigger debits, but would not receive recognition of the same. And there would be less incentive for employers to control losses.

This proposed change restores equity to the Plan. Countrywide, 78% of employers will experience little impact or in fact, benefit from the change.

For the 22% of risks that are expected to see bigger debits because of the split point change, there are two things to note:

- NCCI's transition plan will spread the full impact of the split point change over three years
- There may be other things in the formula other than the split point change that impact the final modification
  - New year of experience added and old year dropped from the modification calculation
  - Development of losses from older years included in the modification calculation
  - Change in the ELR due to loss cost change for the classes in which the insured has exposure

22. How can I learn more about experience rating and this split point change?

For a detailed explanation of the experience rating modification and how it is calculated, please see each of the following located at ncci.com under the Education tab:

- ABC's of Experience Rating (downloadable brochure)
- "How to Understand Your Worksheet" Webinar on Demand
- "Understanding NCCI's Filed Experience Rating Plan Changes" Webinar on Demand
- "Introduction to Proposed Experience Rating Plan Changes Item E-1402" Webinar on Demand
- "Understanding the Filed Experience Rating Plan Changes-Item E-1402" Webinar on Demand (which includes several hypothetical examples of how the split point change could impact employers)

Each of the above is accessible by the public and free of charge.