MODIFYING YOUR WORKERS COMP MOD

The National Council of Compensation Insurers (NCCI) proposed significant changes to the calculation of the experience modification factor (mod) that will take effect in most states in 2013. Mods historically have been a metric for Workers Compensation claim loss frequency; now mods will be a measure of both claim frequency and severity. These changes may materially alter the workers' compensation premiums for some employers and are intended to better reflect increased wage benefit levels and medical cost inflation – thereby enabling more sensitivity in the mod calculation to differentiate the claim experience of an individual risk.

HOW TO PREPARE FOR THIS CHANGE

In order to prepare for this change, we suggest that you ask your Willis Client Advocate to prepare a test calculation to estimate what your new mod is likely to be.

Your Willis team can work with you to review your individual data that was reported on the Unit Statistical Reporting Card by your insurer(s) to the rating bureau(s) to make sure they are accurate with respect to your losses, payroll and class codes. Once armed with the knowledge of how your mod is likely to change, you can then evaluate your options.

While you cannot change the calculation – it is mandated by regulation – we do appreciate that every penny counts in your business. This process may create the opportunity to invest in your pre-loss initiatives to drive your costs down. Your Client Advocate, working with Willis' Strategic Outcomes Practice, can assist you in this endeavor. Other cost mitigation strategies may include marketing your program (as most insurance carriers have discreet rates), changing the structure of the insurance

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program to provide higher retentions or modifying the rating basis of your program.

WHY A MOD IS IMPORTANT

The workers' compensation mod factor is a component of the ratemaking formula used to adjust a manually rated premium for the difference between a particular insured's inherent risk and the average risk for all insureds with payrolls in the same class codes.

In the simplest terms, workers' compensation premium is calculated by:

Rate X Exposure (i.e., Payroll) X Mod = Premium

This difference is assumed to be reflected by the insured's actual historical loss experience, to the extent it is actuarially credible, compared to what would be expected for an insured having similar payrolls assigned to the same class codes.

Application of the modification factor in the ratemaking formula can result in a premium that is either lower (a credit mod) or higher (a debit mod) than the unmodified manual premium. An employer that has a credit mod of .75 would benefit from its premium being based, essentially, on 75% of its prevailing rates; whereas an employer with a 1.25 debit mod would pay a premium based on 125% of its prevailing rates.

From a direct cost standpoint, this change is of particular importance to insureds that purchase insurance on a guaranteed-cost basis, since the mod is applied to the full manual premium. In terms of the premium base (to which the basic expense factor, tax multiplier, and the excess loss premium factor apply) and the determination of the attachment point for minimum and maximum premiums, the change can affect insureds that purchase retrospectively rated insurance programs. While insureds that purchase high deductible programs may see less of an impact in their risk transfer premiums they still may see this change impact the assessments and surcharges.

Aside from the cost aspect, as previously mentioned, the mod may be even more important for insureds that are required to bid competitively for contracts, since many times, as part of the bidding process, a mod less than a specified threshold (e.g., 1.00) is used to determine whether a company will be deemed qualified to bid.

WHAT IS CHANGING IN THE MOD CALCULATION

The major change in the mod calculation is the increase in the cutoff threshold for claims – referred to as the "split point." Split points are used for apportioning losses to theoretical primary and excess layers from actual claims that occurred during the experience period considered in the calculation formula. The split point will increase from the current $5,000 to:

- $10,000 for 2013
- $13,500 for 2014
- 15,000 for 2015

This split point will be automatically indexed for claim cost inflation in future years. Average claim severity has increased over time due to inflation in medical costs, wages and benefit levels and, as such, a higher percentage of claims have loss severities that exceed the old split point. Actual primary losses are given more weight than actual excess losses in the mod calculation, so the NCCI felt the formula using the old split point no longer adequately reflected the true difference between the insured's inherent risk and the average risk in the same exposure class, since a higher percentage of the insured's actual losses were receiving less weight in the formula.

The maximum mod cap also changed and this cap varies based on the size of the insured as measured by comparing expected losses for that particular insured to the state's average claim cost. NCCI felt that the old formula produced caps that were too low for smaller insureds. The formula change they are implementing will produce maximum mod caps that are no lower than 1.10.

The anticipated effects of these changes are:

- Small insureds that currently have a limited mod may see their mod increase
- Larger insureds that currently have a limited mod may see their mod decrease

Other changes to the calculation with respect to weighting methodology and the requirements to qualify for experience rating are under consideration for future implementation, but no conclusions have been reached yet!

How the change will affect the mod for a particular insured is difficult to predict and the best way to estimate the effect is by running a test mod calculation using the new factors once they are approved.

Willis stands ready to assist should you have any questions or concerns.

HOW MODS ARE CALCULATED

Experience Mod = {Actual Losses below the Split Point + (W x Actual Losses Above the Split Point) + [(1-W) x Expected Losses above the Split Point] + B}/{Expected Losses + B}

The split point is $10,000 in 2013 and will be increasing as previously indicated in future years.

In computing actual losses above the split point, medical-only losses are counted at 70% and subject to state-specific single and multi-claim loss limitations.

[**Note:** *The experience period corresponds to the most recent policy periods with effective dates between 57 months and 21 months prior to rating effective date subject to a maximum of 45 months.]*

W is an actuarially determined weighting factor between 0 and 1 that is assigned based on the size of the insured as measured by premium. W will be higher for larger insureds and therefore give more weight to their actual excess loss experience than would be the case for smaller insureds.

Expected Losses are calculated by applying an expected loss ratio (ELR) times manual premium.

The *D ratio* is actuarially determined and used to split expected loss calculated by applying the ELR to manual premium into primary and excess portions.

B is an actuarially determined stabilizing value that varies with expected loss and limits impact of a single large loss in the experience period on the calculation.

The split point, W, ELR, B and D Ratio are specified in the experience rating manuals.

The Mod for a particular risk will be capped at:

Maximum Experience Mod = 1.10 + 0.0004 x Expected Losses/(State Average cost per claim/$1,000)

For an intrastate risk, the maximum experience mod cap will be based on the state with the most expected losses. Occasionally, we see mods that are in excess of 2.0 and although it looks as if this formula could not yield such a high mod rate, frequency and severity can deliver that result.

As mentioned above, additional changes contemplated for the future by NCCI but not yet implemented include a revised weighting formula that eliminates the W and B factors and substitutes credibility weights that will not vary by state as W and B do now.

The resulting experience modification factor is applied to premium computed by multiplying manual rates by class and state to associated estimated payrolls in $100 units in those classes for those states in which the insured has payroll.

EXAMPLE

Suppose the insured had three claims: $5,000; $7,500; $15,000.

The Primary and Excess losses for the formula would be:

LOSS	PRIMARY (OLD)	PRIMARY (NEW)	EXCESS (OLD)	EXCESS (NEW)
$5,000	$5,000	$5,000	$0	$0
$7,500	$5,000	$7,500	$2,500	$0
$15,000	$5,000	$10,000	$10,000	$5,000

As you can see, the new split point shifts more loss to the primary layer and less to the excess layer.

Suppose further that W is .2, B is 100,000 and the expected losses obtained by applying the ELR to the insured's manual premium is $20,000 and suppose the D-ratio is 70%.

The experience mod calculation using the old split point of $5,000 would be:

[$15,000 + (.2 x $12,500) + .8 x (.3 x $20,000) + $100,000]/[$20,000 + $100,000] = $122,300/$120,000= 1.02

The experience mod calculation using the new split point of $10,000 would be:

[$22,500 + (.2 x $5,000) + .8 x (.3 x $20,000) + $100,000]/[$20,000 + $100,000] = $128,300/$120,000 = 1.07

This is only an example for illustration purposes and the actual experience mod might not change as much as indicated because W, D, and B as well as the ELR have all probably been adjusted to reflect changes resulting from applying the new split point.

Different claim numbers might produce a mod change that would result in a reduction of the new mod compared with the old mod.

Most states will use the interstate mod which is based on the combined loss and exposures of all states where it applies and where the insured has payrolls. There are a few states that neither follow NCCI actions (CA, NJ, PA or DE) nor have accepted the 2013 calculation changes (WI, MI, MN or TX). Insureds with payroll in these states may have a separate mod in each of these states. Willis will continue to follow the actions of these states and advise our clients as additional information becomes available.

In order to qualify for experience rating treatment, an insured must exceed the minimum standard premium size thresholds, which vary by state from approximately $2,500 to $11,000. An insured may not qualify or may be assigned an experience mod of 1.00 (which produces no adjustment to manual premium) if they have not been in business long enough or there has been a change in ownership as defined in the experience rating manual.

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