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Managing for the Long-Term

by Urban E. Leimkuhler, FCAS, MAAA, and Charles Brophy

Recent years witnessed the exit of several grand old names from commercial property and casualty insurance. The demise of these significant operations led by experienced managements was prompted by multiple factors, but in all cases unsatisfactory underwriting results were a primary cause. What these organizations leave behind are universal lessons for other commercial property and casualty risk bearers. The two key competencies associated with successful management of an insurance enterprise are: (1) Underwriting and (2) Management of Expenditures.

Underwriting

At its essence, insurance entails the successful management of cash flows. Cash receipts from operations and associated investment flows must be sufficient to cover future cash outflows. If the balance of these flows does not constitute a positive net present value, the enterprise is destroying value and liquidating its capital.

Success in property and casualty insurance underwriting requires successful balancing of these flows to achieve a positive net present value, covering the cost of capital. As such, it is the core management discipline of all risk-assuming enterprises, including insurers and self-insurers. "Underwriting" involves processes that relate to the assumption and ongoing

management of risk, including new business risk selection, pricing, and continuing management of the in force business portfolio. Appropriately viewed, underwriting is a complex series of processes and activities that must be undertaken systematically and consistently in order to achieve targeted levels of performance. The design and execution of this business process is an important determinant of cash outflows. Successful execution is required at every step in each sub-process and activity.

Our experience as consultants is that company managements often underestimate the steps necessary for underwriting success, resulting in sub-optimal levels of performance. Why? Perhaps because they have underestimated the complexity, challenge, discipline, and monitoring requirements needed to ensure effective underwriting performance on a large number of individual risks in a dynamic economic environment. In short, they fail to see underwriting as the professional, technical discipline it is. A key factor in many cases appears to be the lack of investment in underwriting training and professional development. Many risk enterprises have sharply reduced these activities as part of their drive toward a "lean and mean" cost culture. Investment in underwriting intellectual capital is the wrong place to cut if it is the core value of the enterprise.

Unfortunately, some company managements have been unable to design and manage the process and achieve results sufficient to support continuation of underwriting activities. The failures may include ineffective underwriting strategy, improper management of underwriting authority, lack of underwriting expertise, or inadequate tools (particularly to monitor rate adequacy). Poor execution or ineffective metrics for monitoring the complex series of processes and activities that represent underwriting can also lead to underwriting failures. Recent price increases have enabled companies to mask underwriting weaknesses but these will be exposed as markets inevitably soften. Strong underwriting companies will be best positioned to capitalize at the expense of weaker players.

Management of Expenditures

The fact that risk assumption is a cash-flow business should also focus management on a second major discipline: management of business processes. After loss and adjustment expenses, other expenditures are the balance of the cash outflows to be managed. This is the other side of the coin in evaluating the underwriting process, since the process and its costs are inextricably linked.

Recent years have witnessed a culture of “big bang” expense initiatives or restructurings. These “one time events” are presented as the cure for previous inadequacies in expense management. All too often, they resemble a crash diet—temporarily impressive, but not a lasting solution and often with hidden, serious side effects such as the reduction in underwriting expertise noted above. This reactive approach to managing expenses does not reflect current best practices in the industry. A number of the leading performers in the industry have institutionalized the attack on efficiency using teams of process engineering professionals for an ongoing series of business process reengineering assignments. This addition of business process teams with a charter for continuous improvement and

the decentralized deployment of such experts in operating units appear to be growing trends.

In a competitive pricing environment, company underwriters with an expense advantage clearly have an edge over their peers in the competition to write at a positive net present value. Management must focus both on the total level of expenditure and the contribution to ultimate returns of each component of expenditure. The industry results of recent years suggest improvement opportunities in both areas. Leading operations have competitive combined ratios coupled with superior operational execution indicating comparatively effective internal allocation of these resources. Leading performers seem most inclined to undertake a continuous proactive review of expenses associated with best operating practices, while less successful organizations follow a more passive “don’t fix it if it’s not broken” culture.

What About Other Core Disciplines?

Our colleagues in actuarial, finance, and claims will each make a case for their disciplines, and all are valuable. However, middle of the road investment performance is a commodity service with many companies outsourcing investment management to one or more professional management firms under supervision. Companies should be prepared to survive and prosper with “middling” investment performance. Underwriters certainly consider investment income but quality underwriting does not presuppose excess returns. The recent boom and bust cycle in equities clearly hurt those companies attempting to achieve higher returns with a more volatile asset mix when the equity market turned downward. This suggests a strategy of seeking high investment returns to compensate for weak underwriting performance is not a reliable solution in the pursuit of continuity and survival. Actuarial science is a key input to the underwriting discipline. Yet, failures in underwriting performance usually result

from weakness in integrating that discipline into underwriting decision making and monitoring—not from mathematical failures by the actuary. Sound claim management is clearly a necessary component of success, but the underwriter who consistently assumes risks at a negative present value can hardly blame the claims department for being unable to fix the mistakes on the back end.

The Morals of the Story

There are two key morals for management:

- First, based on recent industry events, there is no discipline that requires greater focus than underwriting and no core competency is more important than the capability to monitor prospective

cash flows correctly. Proper development of underwriters and retooling monitoring approaches are activities essential to managements of all risk bearers. This will be an even more critical differentiator between winners and losers in the future.

- Second, management of expenditures is a necessary component of management of cash flows and continuous proactive process management to control expenses is superior to the reactive “big bang” approach.

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California Workers' Compensation Reform

by Guy A. Avagliano, FCAS, MAAA

During his inauguration speech last January, Insurance Commissioner John Garamendi said about the state's workers' compensation system, "California has the highest premium costs in the nation. However, benefits for injured workers' remain in the lower third of all states. That is the definition of a broken system."

Having addressed benefits with AB 749, which took effect January 1, 2003, the Legislature turned its attention to the delivery system. AB 227 and SB 228, which took effect earlier this year, address medical fee schedules, chiropractic and physical therapy visits, medical utilization guidelines, vocational rehabilitation, and the presumption of the treating physician, among other areas. Some of these reforms are expected to impact costs both prospectively and retrospectively.

Estimated Impact

There are a number of published estimates regarding the expected impact of the reforms on 2004 pure premiums. The actuarial committee of the Workers' Compensation Insurance Rating Bureau of California (WCIRB), the state's official statistical advisory organization for workers' compensation, provided two savings estimates: 13.3% and 15.7%. The California Department of Insurance (CDI) also provided two estimates. The CDI's in-house actuaries estimated the savings at 16.6%, while the insurance commissioner,¹ relying on other information presented during the rate hearings, selected 18.0%.

¹ AB 227 gives the commissioner the authority to decide on the appropriate savings that should be reflected in insurance rates.

Distribution of Costs

The first step in quantifying the reform impact is to establish the current distribution of workers' compensation costs. Figure 1 (on page 5) displays the components of the 2004 pure premiums on a pre-reform basis.

Medical costs, which were less than indemnity every year until 1997, are now the dominant component. Most of the new reforms address medical costs in an effort to stem the growth that has led to eight consecutive years of double-digit severity increases. Figure 2 (on page 5) displays the key components of medical expenses.

Overview of Reforms

Table 1 (on page 6) shows the various components contributing to the WCIRB estimated savings.

Outpatient Fees. The reforms limit the maximum facility fee in an ambulatory surgical center to 120% of the Medicare fee for the same service performed in an outpatient hospital. A report prepared for the Commission on Health and Safety and Workers' Compensation (CHSWC) estimated this would reduce outpatient fees by 41% or 4% of total workers' compensation costs; this is the largest single reform affecting medical costs.

Chiropractic. In 1995, chiropractors ranked as the fourth highest physician specialty in terms of cost. In 2002, chiropractors were the number one ranked specialty, accounting for 18% of all classified physician costs. The new reforms cap the number of visits per claim at 24. According to California Workers' Compensation Institute, 29% of claims with at least one chiropractor visit have more than 24 visits and 4%

have over 100 visits. Limiting visits to 24 per claim will eliminate 45% of chiropractic costs, all else equal.

There are several factors that partially offset these savings. First, the number of modalities per visit may increase. Second, the number of visits may increase on claims currently receiving less than 24 visits. Also, insurers may voluntarily allow an injured employee additional visits. Finally, the cap only applies to 2004 and later accidents, which may result in more treatments on older claims as chiropractors seek to replace lost income.

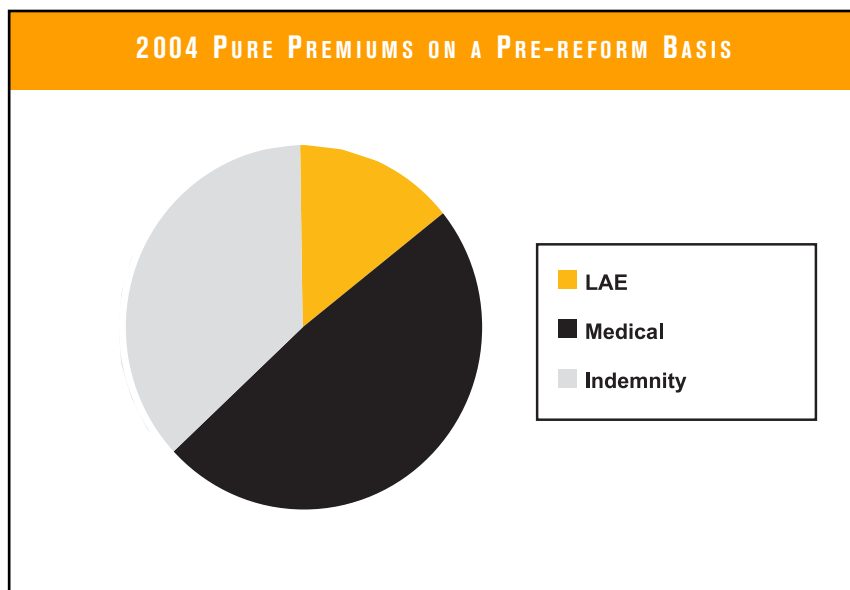
Physical Therapists. The number of physical therapist visits is also being capped at 24 per claim. The issues discussed above for chiropractors also affect physical therapists. This reform is expected to eliminate 40% of physical therapy costs.

Pharmaceutical Fees. Pharmacy costs are one of the fastest growing components of medical costs, quadrupling between 1996 and 2002. The new legislation requires generic drugs to be used, if available, unless the physician prescribes a specific brand. The WCIRB has estimated this will reduce pharmaceutical costs by 37%.

Physician Fees. Generally, physician fees will be reduced 5% below existing workers' compensation schedules for services provided during 2004 and 2005. However, certain procedures (those currently below the Medicare rate) are exempt from this reduction. In order to

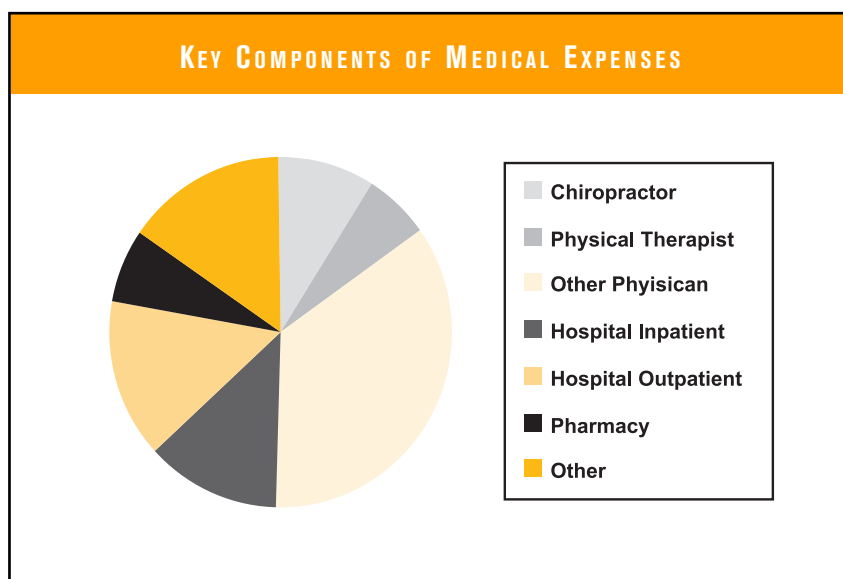
achieve overall savings of 5%, some fees must be reduced by a greater amount, which has yet to be done. Thus, a portion of the savings estimated by the WCIRB is not likely to materialize.

FIGURE 1



Sources: WCIRB

FIGURE 2



Source: WCIRB

TABLE 1

REFORM COMPONENTS		
Component	Low End	High End
Outpatient Fees	-4.1%	-4.1%
Chiropractors	-2.2%	-2.2%
Physical Therapists	-1.5%	-1.5%
Pharmaceutical Fees	-1.0%	-1.0%
Physician Fees	-0.3%	-0.3%
Inpatient Fees	+0.5%	+0.5%
Other Utilization	0.0%	-2.8%
Vocational Rehab	-5.0%	-5.0%
Other	0.0%	+0.3%
Total	-13.3%	-15.7%

Note: Totals do not add due to rounding. Source: WCIRB.

Inpatient Hospital Fees. Maximum reasonable fees for inpatient services will be limited at 120% of the Medicare fee schedule. An analysis prepared for the CHSWC comparing actual costs to the Medicare fee schedule concluded that this change will result in a small increase in expected costs (i.e., inpatient costs are currently reimbursed at a rate less than 120% of Medicare).

Medical Treatment Guidelines. Out of control medical utilization is perhaps the most often cited reason for spiraling medical costs. Under the current system, the primary treating physician has the presumption of correctness for medical treatment. AB 749 repealed this presumption for 2003 and later accidents. SB 228 extends this presumption to all prior claims. The administrative director (AD) is charged with establishing an Official Medical Treatment Utilization Schedule by December 2004. The updated American College of Occupational and Environmental Medicine (ACOEM) utilization schedule will be in effect from approximately April to December, or later if the AD's schedule is not completed.

Most observers agree that medical utilization controls have the potential to dramatically reduce costs. Dr. Jeff Harris, editor of the first edition of ACOEM, told the WCIRB actuarial committee that as much as 90% of workers' compensation medical payments were "medically unnecessary" in the sense that they did not result in healing the employee any sooner than if they had not been treated.

However, there is significant disagreement over whether the current legislation will realize those savings. Proponents cite judges who have welcomed the new guidelines as a way to deny medically unnecessary treatments. Opponents point out that the guideline presumptions are rebuttable with the preponderance of evidence. They also point out that the guidelines tend to be general in nature and lack objectivity. They are concerned that administrative judges will be reluctant to deny medical treatment to injured employees that the treating physicians believe are necessary.

The expected savings are difficult to estimate because the official schedule must still be constructed and the ACOEM update was not completed before the 2004 pure premiums were filed. Also, medical expenses on 2004 policies will be paid over the next fifty or more years, over which time the official guidelines may change many times. Finally, a portion of the savings from the utilization guidelines has already been reflected in some of the other reform items, potentially resulting in the double counting of some savings.

Vocational Rehabilitation. The only significant change directly impact indemnity costs relates to vocational rehabilitation. The reforms repeal the

existing system, which allowed up to \$16,000 per claim. This is being replaced with an educational voucher system with maximum benefits of between \$4,000 and \$10,000 depending on the extent of injury. The vouchers are non-transferable and are subject to strict eligibility standards. To be eligible, the employee must be out of work at least 60 days after the termination of temporary disability benefits and not received a qualified return to work offer. The WCIRB estimates only one in eight permanently disabled employees will qualify for this benefit. The reform eliminates 100% vocational rehabilitation costs (on 2004 and later accidents) and replaces them with the much less expensive educational vouchers; the expected savings are 5% of total costs.

Impact of Rate Adequacy

AB 227 gives the commissioner the final authority to determine the credit the pure premiums should reflect for the reforms. As mentioned earlier, the commissioner's estimate (18%) is somewhat greater than the range developed by the WCIRB's Actuarial Committee (13.3% to 15.7%).

However, in addition to the impact of reform savings, the commissioner's decision on 2004 pure premiums departed from the WCIRB's recommendation in a number of places. As shown in Table 2, the

approved pure premiums are 10% to 12% below the WCIRB indicated range. More than half of that relates to a difference of opinion on traditional ratemaking parameters and methods. The WCIRB's methodology is very responsive to recent experience and despite significantly under-estimating pure premiums in recent years, has been more accurate than traditional methods during periods of rapidly increasing costs. The methodology differences between the filed and approved pure premiums signal that the CDI believes that the conditions that made the WCIRB's extreme methodology acceptable in the past no longer exist. In effect, this represents an additional 6% of benefit reform.

Impact on Reserves

In California, indemnity benefits are generally fixed based on the date of injury; subsequent changes in the workers' compensation system seldom have any impact on prior injuries. However, medical treatments are affected based on the date of service, so the reforms are expected to impact medical reserves for accident years 2003 and prior. The WCIRB estimates this will reduce medical reserves as of December 31, 2003, by 15%, which translates to over \$4 billion for the insurance industry.

Insurers and employers retaining a portion of their workers' compensation liabilities should use this figure with caution when attempting to determine the impact on their own reserves. The 15% is relative to the WCIRB's pre-reform estimate, which is based on a highly responsive methodology that projects high medical inflation into the future. Insurers whose reserves were not set using similar methods and assumptions should expect smaller savings, perhaps significantly so.

TABLE 2

FILED AND APPROVED PURE PREMIUMS		
Component	WCIRB Filed	CDI Approved
Reform	-13.3% to -15.7%	-18.0%
Earthquake	+1.8%	+0.0%
Experience	+10.0%	+3.8%
Total	-2.9% to -5.3%	-14.9%

Source: WCIRB and CDI

“I’ll Be Back”

Evaluating the cost impact of the changes is a difficult challenge, hindered by data limitations and the dynamic interaction of the many moving pieces. In fact, the reforms of the mid-1990s included the introduction of the presumption of the treating physician (PTP), which many analysts expected to reduce costs. However, the PTP was cited as one of the major factors increasing costs and has since been eliminated. The ultimate impact of these reforms may never be known with any degree of certainty.

California’s governor, insurance commissioner, Legislature, employers, and labor unions continue to

try to fix this “broken” system. Over 50 workers’ compensation related bills have been introduced in the extraordinary or regular legislative sessions or are still pending from last year. The governor has even discussed putting his reform plan on the November ballot. The outcome is a long way from being decided.

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