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STATEMENT OF BRAD SMOOT
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THE AMERICAN INSURANCE ASSOCIATION
HOUSE INSURANCE COMMITTEE
REGARDING 2018 HB 2487
FEBRUARY 1, 2018

Mr. Chairman and Members:

Thank you for this opportunity to comment on behalf of the American Insurance Association regarding 2018 House Bill 2487. AIA is a trade group of more than 300-member insurance companies who write commercial, general liability, auto, home, life and workers compensation insurance in all 50 states. Our members include companies that are household names, employ thousands of Kansans and may even insure your family or business.

The American Insurance Association respectfully urges the Committee not to endorse the alteration of the workers compensation experience modifier formula as proposed by HB 2487. While we appreciate the problems described by the proponents of this bill, we believe the bill is the wrong remedy for the alleged ailment. The problem here is not the experience mod formula. The problem is that the proponent's business clients are using the experience mod to determine eligible bidders. That was never the purpose of such ratings and the National Council on Compensation Insurance has made that very clear. Please see the attached recent article entitled "Should Procurement Offices Use E-Mods to Compare Contractor Safety? THINK AGAIN." The article concludes, quote "It's not appropriate to use E-mods to compare the relative safety of employers."

We are aware of only one state that uses the mechanism proposed in HB 2487 to adjust individual employer experience mods in the event of an auto related claim (Colorado). That law has been on the books for a couple of decades and no other state has seen fit to replicate that legislation. In fact, another state more recently looked at this issue and chose to go the exact opposite direction – forbidding government entities from using experience mods in evaluating contract bidders (Virginia).

In addition, this bill muddies the waters of the entire workers compensation system. Workers Comp is a "no fault" system, meaning it doesn't matter whether an employee causes an accident on the job, the employer is at fault or some third party. If a worker is injured on the job, he or she is, and should be, entitled to payment of medical care, lost wages and any disability suffered. That is Kansas law and it reflects the bargain struck between employers and employees decades ago. HB 2487 introduces the element of "fault" into the mix, requiring someone to determine if the motor vehicle involved was an "integral part" of the employer's business and that the accident was not caused, wholly or in part, by the employee or the employer.

Nothing in the bill tells us who is to make these fact-based decisions. How that information will be presented. What will be the standards for making those determinations. Whether there will there be appeals allowed. Or how the necessary parties will be notified. The bill raises more process and legal questions than it resolves.

All we know is that the Kansas Insurance Department must adopt rules and regulations to implement this bill by January 1, 2019.

Finally, the workers compensation system relies on experience modifiers and other formula features to distribute the cost of workers comp coverage as fairly as possible. Consequently, when one employer's mod is artificially reduced those workers comp system costs are spread to other Kansas businesses. Please see the statement of the National Compensation of Insurance regarding this bill. This bill would shift those costs to the experience mods of other employers in the state and disrupt the actuarial integrity of the experience mod formula.

In summary, HB 2487, is a small tail wagging a big dog. It does not address the real problem (businesses misuse of E-Mods for bidding purposes) and we think it there are better solutions for Kansas businesses who want to measure the safety record of potential contractors. AIA would be more than happy to work with business organizations and insurance agents to discourage the misuse of experience mods and reduce the likelihood of this situation happening in the future. Thank you.

Should Procurement Offices Use E-Mods to Compare Contractor Safety? Think Again

Industry Information » Insights

By Kathy Antonello, FCAS, FSA, MAAA,
Chief Actuary, NCCI

(NCCI Note: NCCI regularly collaborates with industry stakeholders. The use of experience rating modifications [E-mods] by procurement offices is a topic of increased interest. In this piece, Kathy Antonello shares why it is not appropriate to use E-mods to compare the relative safety of employers.)

In some states, contractors have a real challenge when bidding on new business—if their experience rating modification (E-mod) is greater than 1.00, they might be ineligible for the job. Several articles published in recent years have discussed procurement offices' misuse of E-mods. Despite this, disclosure of E-mods promulgated by NCCI or other rating bureaus continues as a requirement and relative measure of perceived safety practices by contractors bidding on projects.

Following are some of the reasons explaining this improper use:

- **An excellent risk gets misjudged.** A contractor that is at the higher hazard end of a broadly defined construction classification could have a debit E-mod because of the nature of its business.
- **Certain states allow E-mods to be calculated net of deductible recoveries.** Other states do not. Contractors that choose to purchase a deductible policy in a net-reporting state will have lower mods and a competitive advantage. This is compared to identical employers in their own state that do not choose this option or those in other states that do not have this option. In other words, in net-deductible reporting states, a risk can "buy down the mod" by purchasing a deductible, which gives the illusion of better experience.
- **Certain employers are not large enough to be experience-rated.** So requiring an E-mod precludes them from bidding on a project.
- **An employer that pays its employees lower wages than the class average, but has average loss experience, could have a debit mod.** This is because lower wages generate lower payroll, which then generates lower expected losses in the E-mod formula.

For Example

A hypothetical, simplified example based on the last bullet above will show how the E-mod is appropriate for its intended use—modifying the manual premium—and how it can easily be

misinterpreted if used for other purposes.

If we strip the E-mod formula down to just the basics, we can describe it as a ratio of actual-to-expected losses. That is, we will ignore certain elements like primary and excess losses, weights and ballasts, and credibility. Imagine that there are two construction companies—Employer A and Employer B—doing business in the same state and competing for the same contract. Each has 100% of its payroll in a single class code and therefore both employers are alike with respect to their classification mix. It follows that their expected loss rates (ELRs) from NCCI's most recent state filing are the same. In addition, the employers have had the same actual loss experience over the last three years. So the two companies are completely identical, with one important exception: Employer B pays its employees 20% higher wages, and thus its payroll is 20% higher. While higher wages usually mean higher indemnity benefits, that is not always true.

Table 1 shows the calculation of the E-mods for Employers A and B. Employer B has $12 million of payroll, 20% more than Employer A. Both companies were assigned the same single class code and therefore have the same manual rate (5.00) and ELR (1.86).

Expected losses are $186K for Employer A and $223K for Employer B. Note that this does not mean NCCI expects Employer B to have higher losses than Employer A. The expected loss calculation is an intermediate step and an input into the mod calculation. If one were to stop at this point without any context, **Employer B** could be viewed as "riskier" than Employer A.

Table 1: E-mods For Procurement

	Employer A	Employer B	
1) Payroll	$10M	$12M	
2) Expected Loss Rate (ELR)	1.86	1.86	
3) Expected Losses	$186K	$223K	(2) x (1) / 100
4) Actual Losses	$200K	$200K	
5) Experience Rating Mod	1.08	0.90	(4) / (3)
6) Manual Rate	5.00	5.00	
7) Manual Premium	$500K	$600K	(6) x (1) / 100
8) Modified Premium	$537K	$537K	(7) x (5)

The fact that Employer B pays its employees more does not impact its actual loss experience, which is $200K and identical to Employer A. Taking the ratio of actual losses to expected losses leads to an E-mod of 1.08 for Employer A and 0.90 for Employer B. Just as NCCI did not expect Employer B to be "riskier" than Employer A based on expected losses, NCCI does not view Employer A as "riskier" than Employer B simply because it has a debit mod. If one were to stop at this point without any context, **Employer A** could be viewed as "riskier" than Employer B.

The manual premium is $500K for Employer A and $600K for Employer B. Since Employer B is identical to Employer A, there is no actuarial justification for one to pay more for workers compensation insurance. Multiplying the manual premium by each employer's E-mod brings their premium to the exact same level.

When the E-mod is used for its intended purpose—as an adjustment to manual premium—the employer with the higher payroll has its manual premium reduced by a credit mod. In this simple example, the credit mod serves to bring the premium for Employer B down to the same level as Employer A—an appropriate adjustment because they have identical loss experience, classification mix, etc. If the E-mods from this example were used for procurement rankings, the employer with the lower payroll would not get the contract—even though it was identical to its competitor and may very well have bid lower because of its lower payroll costs.

In Summary

It's not appropriate to use E-mods to compare the relative safety of employers. NCCI's *ABCs of Experience Rating* guide states, "In general, an employer with better-than-average loss experience receives a credit, while an employer with worse-than-average experience carries a debit rating." The key words are "in general" and cannot be overlooked, as Table 1 clearly shows.

To learn more, read the ABCs of Experience Rating (PDF), available at **ncci.com**.

Finally: In 2016, Virginia amended its Public Procurement Act to prohibit procurement officers from conditioning eligibility for a contract on a bidder's E-mod. NCCI views this as a positive move. We also believe that furthering the conversation on this subject will help clarify how E-mods should and should not be considered in the procurement process.